

# **Defined contribution workplace pension market study**

September 2013

OFT1505

© **Crown copyright 2013**

You may reuse this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit [www.nationalarchives.gov.uk/doc/open-government-licence](http://www.nationalarchives.gov.uk/doc/open-government-licence) or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: [psi@nationalarchives.gsi.gov.uk](mailto:psi@nationalarchives.gsi.gov.uk).

Any enquiries regarding this publication should be sent to us at: Marketing, Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX, or email: [marketing@oft.gsi.gov.uk](mailto:marketing@oft.gsi.gov.uk).

This publication is also available from our website at: [www.oft.gov.uk](http://www.oft.gov.uk)

.

# CONTENTS

Chapter/Annexe	Page
Glossary of terms	7
1 Executive summary	13
Analysis of the buyer side of the market	15
Competition on the key elements of value for money	16
Competition on charges	17
Competition on quality and governance	20
Other potential risks associated with AE	21
Recommendations	23
Provisional decision on a Market Investigation Reference	29
2 Introduction	32
The OFT's mission and powers	32
Background on the OFT's DC workplace pensions market study	33
Scope of the market study	34
Research and analysis performed	36
Structure of this report	37
3 Background: DC WORKPLACE PENSIONS landscape	39
Introduction	39
How pensions work	39
The different types of pension	40
The market for DC workplace pensions	43
The role of the employer and trustees	44
The role of advisers and consultants	45
Pension providers	47
Third party administration	48
Investment management	49
Regulatory oversight	49

	The role and powers of the Pensions Regulator	50
	The role and powers of the Financial Conduct Authority	51
	The role of the Prudential Regulation Authority	52
	Other redress mechanisms	52
	Savings trends and recent policy developments	53
4	The Supply Side	60
	Introduction	60
	Market structure	60
	Market size	61
	Market players	62
	Market shares and concentration	63
	Barriers to entry	66
	Economies of scale	66
	Regulatory barriers	68
	Reputation	69
	Evidence of entry	69
	Competition between providers	70
	Value for money and the dimensions of competition	70
	Switching	72
	Conclusion	76
5	Ability of employees and employers to drive competition	78
	The structure of decision making over DC work based pensions	78
	Employees' ability to drive competition	80
	Employee understanding and levels of engagement	80
	The mechanisms available to influence decision making	83
	Employers' ability to drive competition	84
	Knowledge and resources of employers	85
	Additional structures or resources employers can put in place	87
	The use of an adviser	89

	The use of trustees	90
	Employers' incentive to drive competition	91
	Employers' priorities when choosing a pension scheme	91
	Conclusion	95
6	Charges and costs of investing	98
	Introduction	98
	How charges are levied on pension schemes	98
	Analysis of AMC	99
	Distribution of AMC	102
	Competition on charges	105
	AMDs	106
	Transparency and comparability of charges and costs of investing	108
	Individual pricing of schemes and the competitive impact of switching	114
	Higher charges on pre 2001 schemes	116
	Conclusions	121
7	Quality	123
	Introduction	123
	Elements of scheme quality	123
	Competition on quality of administration and member communications	125
	Quality of investment propositions and performance	128
	Quality of governance	131
	Trust based schemes	132
	Large single employer trust based schemes	133
	Small and medium sized single employer trust based schemes	134
	Cross-cutting issues in single employer trust based schemes	135
	Master trusts	135
	Contract based schemes	136
	Conflicts of interest in default fund design	137

The OFT's concerns about contract based governance	138
Current governance initiatives	140
Conclusion	142
8 The Changing Structure and Dynamics of the UK Workplace Pensions Market	144
Introduction	144
Risks arising from the way in which providers and advisers compete in the short term	144
Employers' priorities for AE may result in providers not competing on all elements of value for money	145
Employers may choose a pension scheme without the help of an adviser	147
Employers may not recognise conflicts of interest as advisers supply additional services in the sector	148
Risks arising from the way that competition may develop in the longer term	149
Anticipated rates of switching may be insufficient to maintain ongoing competitive pressure	150
Consequences of providers failing to achieve sufficient scale	151
Conclusion	154
9 Recommendations and provisional decision not to make a market investigation reference	156
Recommendations	156
Consideration of a Market Investigation Reference	167
The reference test	168
Exercise of the OFT's discretion	168
Provisional decision not to make a market investigation reference	169
Alternative powers	170
Undertakings in lieu	171
Appropriateness of an MIR	171
Availability of remedies	173
Conclusion and consultation on the OFT's provisional decision	174

## **Glossary of terms**

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 fund management	The management of assets in which a fund manager actively selects particular stocks at particular times, with the aim of achieving higher than average growth for the assets in question.
Active member	A member of a pension scheme who is at present accruing benefits under that scheme.
Active member discount (AMD)	A charge 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.
AUM (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.
Decumulation	The process of converting pension savings into a retirement income.
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.
Employment Benefit	A firm of advisers that gives advice to



Consultants (EBC)	employers on the benefit packages, including pensions, which they might offer to their employees.
Final salary schemes	Another name for a defined benefit 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.
Financial Services Authority (FSA)	On 1 April 2013 the Financial Services Authority (FSA) split into two regulatory bodies - the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).
Fund Management or investment management Group personal pensions (GPP)	The business of dealing with the investment of sums of money on behalf of clients. A pension scheme which is organised through the employer, but still takes the form of individual contracts between the employee and the pension provider.
Group stakeholder pension (GSHP)	A group stakeholder pension is a collection of individual pension plans set up as a group.
Hybrid schemes	A hybrid scheme is a mixture of defined benefit (DB) and defined contribution (DC).
Independent Financial Adviser (IFA)	An independent financial adviser is someone who is authorised to provide advice and sell a wide range of financial products.
Individual Personal Pension (IPP)	A pension scheme taken out by an individual for their own benefit and to which only they make contributions.
Intermediaries	Advisers
The Investment Management Association (IMA)	The IMA represents the UK investment management industry.

Investment platform	An online service that allows investors access to buy and hold different investment products in one place.
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.
Memberships	The number of members in a scheme (an individual can be a member of multiple pension schemes)
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.
National Employment Savings Trust (NEST)	NEST is a defined contribution occupational pension scheme backed by the government. It has a public service obligation to let any employer that wishes to use it to do so, regardless of their size.

Occupational pension	A pension which is provided via the employer, but the pension scheme takes the form of a trust arrangement and is legally separate from the employer.
Passive (fund management)	Passive management is a financial strategy in which an investor (or a fund manager) invests in accordance with a pre-determined strategy that doesn't entail any forecasting. The most popular method is to mimic the performance of an externally specified index, such as the FTSE100.
Retail Distribution Review (RDR)	On 1 January 2013, the RDR introduced new rules from the then FSA on how financial advisory companies could operate. These rules included a stipulation that advisers are not able to take commission as a form of remuneration but instead will have to quote a fee for any advice given.
The Pensions Regulator (TPR)	The TPR regulates trust based pension schemes in the UK.
Pension scheme	The arrangement by which an employer and, usually, an employee pay into a fund that is invested to provide the employee with a pension on retirement.
Self-Invested Pension Plan (SIPP)	A personal pension where the individual chooses where to invest his funds instead of giving his funds to a financial services company to manage.
Small and medium enterprises (SMEs)	A SME is defined as a firm with 249 or fewer employees.
Stakeholder pension	Stakeholder pension schemes were introduced in the UK on the 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.
Statement of Investment Principles (SIP)	A written statement of the principles governing decisions about investments for a pension scheme. Trustees of trust based schemes are legally required to prepare and maintain a SIP. Contract based schemes, although not subject to the same legal requirement, may also have a SIP for scheme members.
The Pensions Regulator (TPR)	The TPR regulates trust based pension schemes in the UK.
Trustees	A member of the board of trustees 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.
Treating Customers Fairly (TCF)	The FCA's TCF principles aim to raise standards in the way firms carry out their business by ensuring they act in a way that benefits consumers and increases their confidence in the financial services industry. More information on the TCF principles can be found at: <a href="http://www.fca.org.uk/firms/being-regulated/meeting-your-obligations/fair-treatment-of-customers">www.fca.org.uk/firms/being-regulated/meeting-your-obligations/fair-treatment-of-customers</a>
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.

## 1 EXECUTIVE SUMMARY

- 1.1 Encouraging people to save for their retirement is a critical challenge for the UK Government. The UK has an ageing population so it is of growing importance that individuals are encouraged to save for their income in retirement and thereby limit the overall amount of financial support that the Government may need to provide to retired people.
- 1.2 For most people a workplace pension is a very attractive form of saving. This is because it is tax efficient and because employers also make a contribution.
- 1.3 These considerations lay behind the Government's introduction of automatic enrolment (AE) in October 2012. The policy requires employers to enrol their staff into a workplace pension scheme if their employees meet certain requirements.
- 1.4 AE means that it is even more important to ensure that Defined Contribution (DC) workplace pensions, the type of pension product that will be used in most cases for AE, deliver the best possible value for money because:
  - It is estimated that AE will increase the number of individuals enrolled in DC workplace pension schemes by between six million to nine million people by 2018.<sup>1, 2</sup> The value of the assets invested in DC schemes, which are currently estimated to be around £275 billion, should at least double by 2022.
  - For the first time employees will be placed into workplace pension schemes without making a conscious choice to 'opt in'. Many of these savers will be on low incomes, with little prior experience of savings products.

---

<sup>1</sup> [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/223031/wpr\\_digest\\_0712.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223031/wpr_digest_0712.pdf).

<sup>2</sup> Spence Johnson estimates that there are currently 7.85 million memberships in DC schemes, of which 5.37 million are in contract based schemes and 0.87 million are in bundled-trust based schemes. This is broadly consistent with the number of memberships in the OFT sample, which has 5.49 million in contract based schemes and 1.07 million in bundled-trust based schemes. Spence Johnson, Defined Contribution Market Intelligence 2013, p.14.

- It places new regulatory requirements on many employers who will need to identify which employees are eligible for AE, calculate their contributions, and fulfil the regulatory reporting requirements. Many of these will be small employers with little prior experience of establishing workplace pension schemes, and who may not take advice.

1.5 In January 2013 the Office of Fair Trading (OFT) launched a market study into the market for DC workplace pensions with the aim of examining whether, in the light of AE, competition is capable of driving value for money and good outcomes for scheme members.

1.6 Overall we have found that competition alone cannot be relied upon to drive value for money for all savers in the DC workplace pension market. This arises from the combination of two factors:

- weaknesses on the buyer side of the market. Scheme members are reliant on their employers to make most of the key decisions about their pensions for them and many employers lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term. Good quality, independent scheme governance can help to mitigate the impact of the weak buyer side of the market by ensuring ongoing scrutiny of value for money on behalf of scheme members. However we have found the governance of many schemes across the market is not sufficiently strong to provide this scrutiny, and
- the complexity of the product. DC workplace pensions are complicated products, both their costs 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.

1.7 This report sets out a series of recommendations aimed at:

- improving the governance of schemes in order to improve ongoing scrutiny of value for money on behalf of scheme members

- improving the quality of information available about these complex products in order to make decision making on value for money easier
- ending the current risks of consumer detriment, and
- preventing detriment to pension scheme members in the future.

1.8 The OFT is encouraged by the willingness of the Government, regulators and industry to implement these proposed reforms.

## **Analysis of the buyer side of the market**

1.9 The buyer side of the DC workplace pensions market is one of the weakest that the OFT has analysed in recent years.

1.10 Part of the reason for this is that most employees do not engage with or understand their pensions. Pensions are complicated products, the benefits of which occur, for many people, a long time in the future. Considerable survey evidence testifies to the low levels of understanding and engagement that many employees have in relation to their pensions.

1.11 Furthermore, while the person who takes the risks and rewards of a DC workplace pension is the scheme member, they are not responsible for choosing key elements of the product. Instead, the choice of a DC workplace pension rests largely with the employer.

1.12 However, the evidence we have gathered suggests that many employers may not have the capability or the incentive to drive competition on the key elements of value for money in the interests of scheme members:

- Many employers do not have the necessary understanding of workplace pensions to make good judgments on the value for money of their pension schemes. Those employers without the resources to fund the use of capable trustees, internal governance panels or high quality advice to improve decision making and

monitoring may not get the best value for money for their employees.

- It also appears that many employers do not always prioritise all the elements which we consider to be key to assessing value for money (see below) when they select a scheme. Whilst some employers appear likely to prioritise ensuring that the charges that their employees face are as low as they can be, there is little evidence that many employers prioritise the key elements of scheme quality, such as investment design and performance, or scheme governance. Instead, OFT research suggests that many employers that are automatically enrolling employees into pensions for the first time are likely to prioritise minimising the costs to themselves of setting up and administering the scheme. Employers may also seek to prioritise the interests of scheme members that are current employees, over those scheme members that are former employees.

## **Competition on the key elements of value for money**

1.13 The OFT's focus has been on the key elements of a pension scheme that, when considered together, determine whether contributions are being saved into a scheme which offers value for money. We consider the key elements of value for money to be:

- The charges the scheme member has to pay – including charges paid for the administration of the scheme and for investment management services. Small differences in the level of scheme charges can make a significant difference to the value of a member's accumulated savings at retirement. For instance, a 0.5 per cent Annual Management Charge (AMC) over an employee's working life can reduce the overall value of a scheme member's retirement savings by around 11 per cent, whereas a one per cent AMC can reduce retirement savings by around 21 per cent.<sup>3</sup> Charges on a scheme can change over time.

---

<sup>3</sup> An Annual Management Charge (AMC) is levied as a percentage of scheme members' accumulated savings every year. These Figures assume a starting salary of £26,500 at age 25, and throughout a 40-year investment period until retirement at age 65, annual growth in real earnings of two per cent, combined employee and employer contribution rates of 8.90 per cent, active contributions throughout the investment period, and real



- The quality of the scheme, which includes:
  - the design and execution of the investment strategy
  - administration of the scheme and communication with the members, and
  - the governance of the scheme, which should involve assessments at regular intervals of how well the scheme is delivering on each of the key elements of value for money on an ongoing basis - including the level of charges, investment strategy design and execution, and scheme administration. This ensures that a scheme remains good value for money into the future.

## Competition on charges

1.14 Our view is that buyer side weakness and charging complexity combine to reduce competition on charges. Charges levied on scheme members can be difficult to understand and there are a wide range of different costs and charges. Charges can appear small in percentage terms, and the impact of charges is only felt by members over time. In addition, charges are not paid directly by scheme members or employers but indirectly - usually through annual deductions from the scheme members pension assets. Finally, the people that take decisions on pension products and charges (employers) are not the same as those that pay the bulk of scheme charges (the scheme members). Indeed, some scheme members may have moved employment and no longer have a relationship with the employer. We believe these buyer side weaknesses result in potential consumer detriment arising from:

- poor comparability of charges
- lack of switching and the persistence of legacy schemes, and
- two-tier charging structures.

---

investment returns of five per cent per year. The impact of a 0.50 per cent Annual Management Charge reduces accumulated savings from £440,134.75 to £390,201.78 (11.3 per cent). The impact of a 1.00 per cent Annual Management Charge reduces accumulated savings from £440,134.75 to £346,670.16 (21.2 per cent).

## Comparability of charges

1.15 For schemes set up prior to the introduction of stakeholder pensions in 2001, our evidence indicates there are up to 18 different names for charges that can be paid by members. When stakeholder pensions were introduced in April 2001, the pensions industry moved towards levying a single charge, known as an AMC, although this has not precluded the industry from using other charges as well.

1.16 Despite this simplification, we remain concerned that there is insufficient visibility and comparability of charges to ensure that competition on charges is fully effective. We have two concerns in particular:

- First, employers setting up schemes during the course of AE are likely to find it difficult to compare charges of different pension providers because there is a lack of consistency in the way that charges are presented. Not all providers include all investment management service charges and expenses within their AMC. Further, some master trusts do not use a single AMC charging model, which may further complicate comparisons, and

second, the costs associated with investment management transactions (the buying and selling of assets within a fund) are often not visible. Where costs and charges lack definition and visibility it is unlikely that competition can effectively be brought to bear on them. Moreover, we are concerned that non-visible charges add to the potential for conflicts of interest to emerge in the supply chain such that charges may not always be managed down in the interests of scheme members. While we have not received specific evidence of inflated transaction charges, a number of industry experts have pointed to the potential for conflicts to exist. Disclosure of transaction costs and independent scheme governance could help to ensure that this potential conflict of interest is managed.

## Switching and the persistence of legacy schemes

- 1.17 The OFT has found that, to the extent that competition on charges takes place, it tends to focus on the level of the visible AMC. The average AMC on new contract based schemes and bundled trust based schemes written each year has fallen from 0.79 per cent in 2001 to 0.51 per cent in 2012.
- 1.18 However, although AMCs on new business have fallen, many scheme members are not benefitting from these reductions in charges due to a lack of switching. Scheme members only benefit from lower charges if employers or trustees regularly switch schemes or use the threat of switching to renegotiate terms. It appears that instances of such switching are particularly low for smaller schemes.
- 1.19 Based on the evidence we received, the lack of switching in the market may have resulted in around £30 billion of contract and bundled trust based assets (approximately one quarter of the total assets in those schemes) being left in schemes with charges at risk of being poor value for money. We estimate AMCs on schemes sold before 2001 (so-called 'legacy schemes') are currently 26 per cent higher on average than those sold after April 2001.<sup>4</sup>
- 1.20 Further, 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. Nevertheless, based on our assessment of the range and scope of these additional charges, we consider there is a significant risk that the overall level of charges on schemes sold pre 2001 are considerably higher than more recent schemes.

## Two-tier charging structures

- 1.21 We also have concerns about the practice of increasing AMC members pay when they stop contributing to a pension scheme. These types of charging structures, known as active member discounts (AMDs), are

---

<sup>4</sup> This equates to an average increase of 0.16 percentage points on the AMC of pre 2001 schemes. These averages are calculated on the basis of scheme charges on 1 January 2013

used by a number of major pension providers. We estimate that there are currently around 10,000 contract based schemes with AMDs, containing around £13.4 billion of assets. The OFT has found that, on average, members of these schemes can expect their AMC to increase by 0.47 percentage points if they stop contributing.

1.22 The following factors lead the OFT to believe that AMDs may lead to consumer detriment:

- given scheme members' lack of understanding and engagement, we think it possible that many scheme members will be unaware of their charges rising when they stop contributing to a scheme
- when employers negotiate these charges, we think they may focus on negotiating the lowest possible charges for 'active' members who are likely to be current employees. Those members who no longer contribute to the scheme may not have anybody actively considering whether their charges still represent value for money, and
- some providers have supplied the OFT with evidence that members who no longer contribute to a scheme cost less for providers to administer than those who continue to contribute. The increase in AMC when an employee stops contributing into a scheme may therefore not reflect the cost of administering the deferred member.

## **Competition on quality and governance**

1.23 Based on the evidence we have gathered there appears to be limited competition between providers on scheme quality. We have concerns that the difficulties involved in assessing and comparing scheme quality over the long term make it very difficult to generate competition on the quality of administration, investment strategy and execution across the market.

1.24 Well resourced employers may be able to overcome these difficulties by putting in place good scheme governance that can act as a substitute for any weaknesses in their own understanding of the market. However, AE will see a growth in the number of employers in

the market that do not have the resources to provide ongoing governance or scrutiny of scheme value for money.

1.25 We are concerned that governance gaps have already developed in both contract and trust based sides of the market that increase the risk that members of less well resourced schemes will not get value for money from their pensions in the long term. In particular:

- The governance that providers have 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 us confidence that members of such schemes will not be disadvantaged. In addition, many major contract based providers have a vertically integrated fund management arm. While there might be strong efficiency arguments for this, given the weakness of the demand side of the market and the lack of ongoing scrutiny of value for money, there is a potential for conflicts of interest.
- Evidence indicates that trustees of many small and medium sized schemes and potentially some micro schemes are not regularly scrutinising value for money of their investment choices or scheme administration and that in many cases those scheme's trustees do not have the necessary expertise either.

1.26 Multi-employer master trusts have the potential to offer the independent trustee governance associated with single employer trust based schemes with the scale efficiencies of providers offering contract based schemes. However, we are concerned that some master trusts may not achieve these advantages in practice. In particular there, is a risk that some trustee boards may not be sufficiently independent of the master trust provider to avoid potential conflicts of interest and always act in members' best interests. This risk may not be apparent to employers when choosing a pension scheme.

## **Other potential risks associated with AE**

1.27 We are concerned that employees may be automatically enrolled into schemes that contain in-built adviser commissions that form part of

the overall charge to members. Although setting up such schemes was banned in January 2013, it remains possible to enrol employees into such schemes if they were set up prior to this point. If employees are automatically enrolled into schemes with in-built adviser commissions, this has two undesirable consequences. First, the scheme member may pay the adviser from their charges without realising it. Second, the existence of such schemes creates a barrier to switching because an adviser would lose this commission stream if they advised the employer to switch in future.

1.28 There are two factors that give us particular concern that a significant number of employees could be enrolled into these schemes:

- employers have told us that they are keen to minimise the cost of AE and would therefore be prepared to use their existing schemes for AE, and
- we have been told that in 2012, prior to the ban on setting up these schemes in January 2013, a significant number of new schemes were set up with in-built commission charges for use in AE.

1.29 The OFT is also concerned that some new providers entering the market in the context of AE may not win sufficient business to achieve economies of scale and deliver value for money. In particular, we note that the ease with which it has been possible to set up a master trust has allowed a significant number of new master trust providers to enter the market. There is a risk that inefficient providers may:

- put up charges or reduce the quality of the scheme in order to make their business models viable, or
- exit the market. If this is done in an orderly way, with scheme assets being protected and transferred without penalties, then there may not be any detriment suffered by scheme members.

1.30 We are also concerned that differences in the financial protection that is in place for the assets of master trust scheme members, compared to those for contract based scheme members, may not be understood by employers comparing mass market contract based schemes and master trust schemes.

## Recommendations

### Improving governance to address buyer side weaknesses

1.31 In light of our findings on the weaknesses of the buyer side of the market (see Chapter 5), we would like to see the Government introduce minimum governance standards set for all pension schemes in order to ensure a consistent degree of ongoing scrutiny and assessment of value for money now and into the future.

1.32 We have found that the governance that providers have 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. After discussion with the OFT and the Department for Work and Pensions (DWP), the Association of British Insurers (ABI) and its members have agreed the introduction of Independent Governance Committees which will be embedded within all providers of contract based pensions and bundled trust based schemes.<sup>5</sup> The key elements of this agreement are:

- the Independent Governance Committees should be made up of a majority of independent members and have an independent Chair
- the Committee will have both the expertise and the resources to carry out its duties
- the Committee will consider all the key elements of the value for money of schemes, and
- if the Committee identifies a problem with the value for money that a scheme or number of schemes offer, it will report a proposed action to the pension provider's Board. The Board will have a 'comply or explain' duty to act on these recommendations. If the Board fails to act on the Committee's recommendation in a way that satisfies the Committee, then it will have the power to make the matter public, to inform the employee and employer and to escalate the matter to the relevant regulator.

---

<sup>5</sup> The ABI have suggested that smaller companies may choose to employ an independent governing person or firm in place of the Independent Governance Committee. The OFT has not taken a position on this proposal.

1.33 We recommend 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. On the trust side, including master trusts, this standard would need suitable definition and oversight to ensure that trustees are genuinely able to carry out their fiduciary duty, including by moving scheme assets to alternative fund managers and administrators where that is in the members’ interest.

1.34 We consider that these governance standards will help to address a number of problems identified above which stem from weaknesses in the buyer side of the market and complexity of the product. In particular, we would expect governance committees to be able to identify situations where scheme members are getting poor value for money either as a result of uncompetitive charges or poor quality of investment design, and implement changes to the pension product as a result. We would also expect that expert governance will overcome many of the issues of product complexity that arise in trying to assess charges and quality and create more pressure to improve these key elements of value for money.

### **Improving the quality of information available about these complex products**

1.35 In order to make decision making on value for money easier, we have 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.

1.36 In order to address our concerns about the transparency and consistency of charges (see paragraph 1.15), we suggest that, building on the ABI’s current transparency initiative, all costs and charges associated with pension schemes, including those associated with investment management, should be disclosed in a framework that will allow employers to compare a commonly defined single charge.<sup>6</sup>

---

<sup>6</sup> Master trusts that levy other charges, in addition to an AMC, should provide employers with an equivalent comparable single figure.



- 1.37 The only type of costs that the OFT suggests is omitted from this single charge would be investment management transaction costs<sup>7</sup> because in the OFT's view their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the member's interest. However, these costs should be transparently reported and made available to Independent Governance Committees (see paragraph 1.32) who will be best placed to make an informed decision about whether transaction costs represent value for money. To this end, regulators should agree a consistent methodology for reporting comparable information on investment management transaction costs and portfolio turnover rate. We recommend that the Financial Conduct Authority (FCA) undertake this work as part of its planned competition review of wholesale markets.
- 1.38 In order to address our concerns about the difficulties that employers face when assessing and comparing scheme quality (see paragraph 5.22), we suggest that the DWP considers mandating that information about the key elements of scheme quality - such as scheme administration standards, past investment performance and the quality of providers' governance standards – be provided to employers in a comparable format by all providers of AE schemes where no intermediary is involved, building on the joint industry Pension Charges Made Clear code of conduct.<sup>8</sup>

## **Ending the current risks of consumer detriment**

### **Legacy schemes**

- 1.39 As noted in paragraph 1.19 above, we have identified around £30 billion of savers' money in contract and bundled-trust schemes with charges at risk of being poor value for money. In response, the ABI, and those of their members that provide contract based DC pensions, have agreed to:
- carry out an audit of these 'at risk' schemes – covering all workplace pension products sold pre 2001 and all post 2001

---

<sup>7</sup> Costs that are incurred directly as a result of buying and selling of fund assets.

<sup>8</sup> NAPF (2012 ) Pension Charges Made Clear: Joint Industry Code of Conduct, Telling Employers about DC pension charges . Available here [www.napf.co.uk/PolicyandResearch/Charges-code-of-conduct.aspx](http://www.napf.co.uk/PolicyandResearch/Charges-code-of-conduct.aspx)

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.

1.40 We have considered whether a charge cap might be a more effective approach to address the potential consumer detriment arising from legacy schemes. However we concluded that the audit process above is preferable for three main reasons. First, from the evidence we have seen, some legacy schemes may offer value for money benefits such as guaranteed annuities. We are concerned that a blanket approach, such as a charge cap, could result in such benefits falling away. Second, as noted above, we have found up to 18 different names and configurations of charges for legacy schemes. Defining a charge that captures all these configurations and setting the level of the cap on that charge would be difficult in this context. Finally and more generally, charge caps can create a risk of unintended consequences. Set too high, a cap can become a target for providers. Set too low, a cap can create incentives for providers to lower quality and/or impose less visible charges elsewhere. While we would not rule out a charge cap, it should be considered in full knowledge of the different charges and benefits that apply in the market and of the risks that a cap might entail. We consider the audit of scheme charges to be an important part of that process.

#### Small trust based schemes

1.41 There are also around 2,900 small and medium size trust based schemes (with between 12-999 members) holding around £10 billion of assets,<sup>9</sup> many of which appear to be at risk of delivering poor value

---

<sup>9</sup> According to [www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

for money due to lower standards of trustee engagement and capability. It is also possible that some of the 36,000 micro schemes (with between two and 11 members)<sup>10</sup> holding around £160 billion<sup>11</sup> might also be affected by similar issues (although a significant proportion of those schemes are likely to be executive- type or member- directing schemes run by their members and therefore are of less concern).

1.42 We therefore recommend that the Pensions Regulator (TPR), which is responsible for regulating these schemes, should:

- set out how trustees can assess the key elements of value for money of their trust based schemes<sup>12</sup>
- require each trust based scheme to report basic data to TPR on the results of their value for money assessment, with TPR to consider publishing the overall results of the exercise
- integrate this data with their risk framework and make an assessment of which schemes are at greatest risk in order to enable any further regulatory activity to be well targeted, and
- carry out an exercise to establish the key barriers to closing occupational schemes that offer poor value for money and transferring members' assets to alternative schemes.

1.43 In light of TPR's findings, the Government should consider whether there is the potential to put greater onus on trustees to prove their compliance with value for money standards, whether the enforcement powers currently available to TPR are sufficient and whether any barriers to closing trust based schemes should be addressed.

---

<sup>10</sup> [www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

<sup>11</sup> Spence Johnson estimates that there are £183bn of assets in all trust based schemes. TPR estimates that there are £24bn of assets in trust based schemes with 12 or more members. Therefore, there are approximately £160bn in 'micro' schemes.

<sup>12</sup> Trustees will be better able to assess value for money once the DWP and the industry has worked on a common framework for capturing costs, charges, and investment performance in a consistent and comparable way to enable trustees to evaluate the value for money of their scheme.

## **Preventing risks of consumer detriment in the future**

1.44 We also 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. We therefore recommend that the Government consider introducing the following standards for schemes used for AE:

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

1.45 Finally, in light of our concerns about employees to be automatically enrolled into schemes run by providers, particularly some of the master trusts that have newly entered the market that do not have the economies of scale to deliver value for money, we recommend that master trust schemes should demonstrate to TPR that they can deliver ongoing value for money for members on the basis of realistic growth plans and contingencies.

1.46 Further, we believe that there is a significant risk that employers, when choosing an off-the-shelf pension, will not appreciate the different levels of consumer and financial protection that may apply to master trust products compared to contract based products (see paragraph 1.30). The Government and regulators should aim to ensure an equivalent level of protection between these two mass-market products.

## Longer term principles

1.47 We are confident that the recommendations above will address the risks of consumer detriment arising in the short to medium term in the context of AE. This is the urgent challenge to which this report is addressed.

1.48 A longer term challenge remains, however. The structure of the DC pensions market in the UK has resulted from the rapid decline of DB provision and the need to put alternative provision in its place. It has therefore been built largely on the back of structures and products designed for the provision of single firm DB workplace pensions topped up by individual private pensions. Key elements of the DC market – single firm trusts, integrated insurance providers and contract based schemes – are based in this DB tradition.

1.49 One would expect this market structure to evolve as the demand for DC workplace pensions grows. The emergence of master trusts is one example with the potential to offer scale coupled with independent governance. We also note that greater investment flexibility is being built into new contract pension products. However, one consequence of a weak demand side is that product innovations and market structures can take time to evolve.

1.50 We therefore consider it would be helpful for future policy and regulatory initiatives to be informed by longer term principles for how the DC workplace pension market should evolve. In our view, these principles would be:

- Scale: there are significant economies of scale in the purchase of administration and investment, and in the governance of pension schemes. We would expect the market to take greater advantage of these scale economies over time, but policies could help accelerate this process and remove barriers to scale while avoiding concentration.
- Alignment of incentives: better alignment of the incentives of employers, trustees, advisers, providers and investment managers with those of scheme members is the best way to ensure that

actions are taken in the interest of scheme members. This should be coupled with clear responsibility and accountability for those making choices on behalf of savers. Regulation should promote this alignment and accountability and avoid steps that might result in misalignment of incentives.

- **Robust independent governance:** DB schemes created strong incentives for employers to set up engaged expert investment governance given the risks that employers were exposed to. While some parts of the market may be able to re-create robust governance for DC schemes, there is a role for policy to promote this across the market.
- **Flexibility:** effective governance needs to be backed up by the flexibility to move assets and change administration. We would expect the DC market to develop products that allow greater flexibility in investment decisions, including products that allow for collective pooling of risk between scheme members. There is however likely to be a role for policy in providing the regulatory context for these developments.
- **Simplicity and switching:** in the interests of promoting switching ,policy should look to promote simpler products, with transparent charges. It should also look to ease the process for employees and trustees of switching between different pension products.

1.51 Our recommendations above are based on these principles and we would advocate for them to be reflected in on-going policy and regulatory developments. The OFT will maintain a keen interest in how this market develops over time.

## **Provisional decision on a Market Investigation Reference**

1.52 The OFT has provisionally concluded that the legal test for making a Market Investigation Reference (MIR) is met.

1.53 However, in light of the fact that there are steps in place to address the competition concerns that we have identified, we have provisionally concluded that an MIR would not be appropriate in this

instance. We consider that the concerns we identified can be tackled most effectively and efficiently by the actions set out above. Further, given that the Government is currently poised to take forward reforms that are likely to impact on competition on charges and quality in the market, we have provisionally concluded that now would not be an appropriate time for such a reference. The full reasoning for this provisional decision is set out in **Chapter 9** of this report.

We are consulting on this provisional decision and responses should be emailed to: [pensions@oft.gsi.gov.uk](mailto:pensions@oft.gsi.gov.uk) by 5:00pm on 31 October 2013.

## **2 INTRODUCTION**

- 2.1 The DC workplace pension market is undergoing an unprecedented period of change. AE will see millions of employees enrolled into pension schemes, many for the first time. For most people to be automatically enrolled, a DC workplace pension will be a very attractive form of saving. This is because it is tax efficient and because employers will also make a contribution to scheme members' retirement investment. However, in order to support AE, the OFT felt it timely to look at how the market operates and consider whether competition can deliver value for savers in the long-term.
- 2.2 Following our study, the OFT is concerned that the DC workplace pensions market is not working well for pension scheme members. The concerns outlined in this report stem from the complexity of DC pensions and weaknesses on the buyer side of the market. It has developed a number of recommendations for how these concerns can be addressed. These views are based on analysis of evidence gathered during our market study on the UK's DC workplace pensions sector, which was launched on 17 January 2013.
- 2.3 This chapter gives an introduction to the OFT and its work on the DC workplace pensions market to date.

### **The OFT's mission and powers**

- 2.4 The OFT's mission is to make markets work well for consumers. The OFT takes a broad interpretation of consumers, including both businesses and final consumers. Market studies are one of a number of tools at the OFT's disposal to address competition or consumer protection problems, alongside its enforcement and advocacy activities.
- 2.5 Market studies<sup>13</sup> involve the analysis of a particular market, or practices across a variety of goods and services, with the aim of identifying and addressing significant aspects of market failure. Market

---

<sup>13</sup> Market studies are conducted under the OFT's general function in section 5 of the Enterprise Act 2002, which includes the functions of obtaining information and conducting research. For more information on market studies, see: [www.oft.gov.uk/OFTwork/marketswork/market-studies-further-info](http://www.oft.gov.uk/OFTwork/marketswork/market-studies-further-info).



studies will consider competition issues, whether there is any consumer detriment and, where relevant, the effect of government regulations. Possible outcomes of market studies include:

- enforcement action by the OFT
- a reference of the market to the Competition Commission (CC)
- recommendations to Government or regulators for changes in laws, regulations or policy
- recommendations for voluntary action by industry participants to address any problems found
- campaigns to promote consumer awareness, and
- a clean bill of health.

## **Background on the OFT's DC workplace pensions market study**

2.6 There has long been concern in the UK that people are living longer but not saving enough towards their retirement. To help address this, the Government has recently implemented AE, a policy aimed at ensuring that more people are saving for their retirement. Under AE, all employers will have to enrol employees earning over £9,480 into a pension scheme and will have to contribute three per cent of their employees' salaries into a workplace pension scheme.

2.7 In January 2013 the OFT launched a market study into the market for DC workplace pensions with the aim of examining whether DC workplace schemes are delivering the best value for money for savers and whether competition is capable of driving good outcomes for scheme members.

2.8 The OFT considered that it was the right time to carry out such a review because:

- it is estimated that AE will bring as many as nine million new savers into DC workplace pensions by 2018.<sup>14</sup> The value of the assets

---

<sup>14</sup> [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/223031/wpr\\_digest\\_0712.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223031/wpr_digest_0712.pdf)

invested in DC schemes, which are currently estimated to be around £275 billion, should at least double by 2022,

- for the first time employees will be placed into workplace pension schemes without them making the conscious choice to 'opt in'. Many of these savers will be on low incomes, with little prior experience of savings products
- it places new regulatory requirements on many employers who will need to identify which employees are eligible for AE, calculate their contributions, and fulfil the regulatory reporting requirements. Many of these will be small employers with little prior experience of establishing workplace pension schemes, and who may not take advice, and
- the way in which the market develops in the early stages of AE could determine the choices available to employers and employees, the ease with which they can make informed choices, and the risks to which they are exposed in the longer-term. The OFT therefore considered it timely to investigate the likely development of the market and to consider whether competition between providers can deliver low cost, high quality pension schemes.

## **Scope of the market study**

2.9 This market study has focused on DC workplace pension schemes sold in the UK. Other types of workplace schemes, such as defined benefit (DB) schemes and indeed other types of pension, such as individual personal pensions have been excluded from the scope. Whilst the OFT recognises the importance of these schemes for consumers, it has focused on DC workplace schemes because these are the savings vehicles that most employers will use for AE.

2.10 We have focused solely on the 'accumulation' phase of the pension product life-cycle, analysing whether the DC workplace pension is offering value for money as a savings product. We focused on the accumulation phase because, as a result of AE, there will be many new savers starting to accumulate pensions and many employers entering the market for the first time. We have not looked at the

'decumulation' phase where the scheme member might buy an annuity or begin drawing down their pension. We are aware, however, that the FCA are conducting a thematic review on annuities and will consider, once the review concludes towards the end of the year, whether a market study is required.

2.11 We gathered evidence that allowed us to examine whether DC workplace schemes are being set up to deliver the best value for money for savers and whether competition is capable of driving good outcomes for scheme members. However, given that the AE programme got underway in October 2012, a particular focus of our evidence gathering has been on the types of schemes (including contract based and master trust schemes) that are most likely to be used for the purposes of AE.

2.12 Although we have excluded individual personal pensions from the scope of our market study, we have included within the scope pensions that began as a DC workplace pension but became an individual personal pension. This occurs whenever a saver decides to leave a contract based workplace pension scheme and doesn't transfer their pot into an alternative workplace scheme. In the course of the market study we have considered:

- whether the buyer side of the market applies sufficient pressure on pension providers and other providers of pension services to ensure that they receive value for money from their pension
- the extent to which competition on the level of costs and charges is taking place
- the extent to which competition is achievable on the key elements of scheme quality, and
- how competition in the market is likely to evolve in both the short and longer term, in light of some of the major reforms that have impacted on the market recently.

## Research and analysis performed

2.13 In the course of our market study we have carried out the following work:

- analysed responses to information requests from 13 pension providers, nine investment managers<sup>15</sup> and seven intermediaries
- reviewed key sources of existing research – including government research and policy documents, academic research and trade press articles
- carried out over 100 stakeholder interviews with market participants – including providers, investment managers, intermediaries and employers
- commissioned four focus groups with small and medium size employers, divided by whether or not they already had a pension scheme
- analysed results of a survey of 30 trustees, and
- held industry roundtables with providers, advisers and investments managers.

2.14 The OFT also used a panel of industry experts to help us test our findings and develop our recommendations. Our experts were:

- Alan Woods, Independent Consultant
- Christine Farnish, Chair, Consumer Focus
- Debbie Harrison, Visiting Professor, Cass Business School
- Rajiv Jaitly, Managing Partner, JAITLY LLP, and
- Robert Hudson, Professor of Finance, Newcastle University.

2.15 The panel have not however seen this report in draft and it does not necessarily reflect the views of the panel members. The OFT would like to thank the panel of industry experts, pension providers,

---

<sup>15</sup> Of which three are external and not vertically integrated with a pension provider.

investment managers, advisers, trustees, trade bodies, the DWP, TPR and the FCA (the successor to the Financial Services Authority (FSA)) who have helped the OFT develop its understanding of the DC workplace pensions market.

## Structure of this report

2.16 The remainder of the report is as follows:

- **Chapter 3** sets out information about the different types of pensions available to individuals in the workplace, provides an overview of recent developments in the pensions market, and considers the different companies active in the market and the roles they play,
- **Chapter 4** sets out our analysis of the provider side of the market, including market concentration and how providers compete,
- **Chapter 5** sets out our analysis of the buyer side of the market and whether it is capable of maintaining competitive pressure on the providers of pension scheme services,
- **Chapter 6** sets out the extent to which competition on the levels of costs and charges is taking place,
- **Chapter 7** analyses the extent to which competition is achievable on the key elements of scheme quality,
- **Chapter 8** considers how the sector may evolve in both the short and longer terms in light of some of the major reforms that have impacted on the market recently and the effect that this might have on competition in the market, and
- **Chapter 9** sets out our conclusion, recommendations, and the reasoning for our provisional decision not to refer the market to the CC.

2.17 The OFT is consulting on its proposed decision not to make a MIR to the CC. It invites comments **by 5pm 31 October 2013**. Comments should be sent to:

**DC Workplace Pensions Market Study**  
**Office of Fair Trading**  
**Fleetbank House**  
**2-6 Salisbury Square**  
**London EC4Y 8JX**  
[pensions@oft.gsi.gov.uk](mailto:pensions@oft.gsi.gov.uk)

### **3 BACKGROUND: DC WORKPLACE PENSIONS LANDSCAPE**

#### **Introduction**

3.1 The DC workplace pension market is complicated and involves many different providers and distributors of workplace pension products. The purpose of this chapter is to introduce the characteristics of a DC workplace pension, how pensions are distributed to savers, and to outline recent changes in the DC workplace pension market. This chapter explores:

- how pensions work
- the different types of pensions available to individuals in the workplace
- the supply of DC workplace pensions
- regulatory oversight, and
- recent trends in the DC workplace pension market.

3.2 The OFT's analysis of how the supply and demand side of the DC workplace pensions market operates and how this affects the charges and quality of pension schemes is discussed in chapters four to seven.

#### **How pensions work**

3.3 Pensions are long-term savings schemes intended to provide an individual with a form of income in retirement. Pensions allow savers to redistribute some of their income during their working life to the period when they are retired. The number of years for which the pension scheme is held, the contributions made by the employee and employer, tax rebates, charges, and investment returns all determine the amount accumulated in the fund and the eventual income payable in retirement.

3.4 An individual's contributions, along with those of the employer, can be invested in a range of assets including property, equity, bonds, and

cash. Each scheme will be set up with an investment strategy and performance objectives for the pension provider or investment manager. Investment strategies may require the mix of assets held in the scheme to be fixed or may require the mix of assets to vary over the lifetime of the scheme. Younger pension savers, for example, may have more capacity for risk than older savers and may therefore be exposed to higher risk assets in their 20s and 30s in the expectation that this will help maximise their pension pot in retirement.

- 3.5 When an individual reaches retirement they may have a number of options by which they can generate income or draw down ('decumulate') the assets that they have accumulated. Individuals can buy an annuity with their accumulated savings, or they may be able to use income drawdown and keep their savings invested in assets. Some schemes may allow individuals to take some of their pension as a lump sum on retirement.
- 3.6 Decumulation is outside the scope of this market study. The FCA has recently launched a thematic review of annuities to consider in more detail whether or not consumers are exercising choice in the market to choose an annuity provider and whether or not they are getting the best value from an annuity.<sup>16</sup>

## **The different types of pension**

- 3.7 There are a number of different types of pension products available to savers, with different features depending on who sets them up, the extent to which savers have a guaranteed level of income in retirement, and the underlying governance structure.
- 3.8 Pensions can be set up as either:
- individual personal pensions, in which the pension is set up by an individual or<sup>17</sup>

---

<sup>16</sup> [www.fca.org.uk/firms/financial-services-products/investments/drawdown-pensions](http://www.fca.org.uk/firms/financial-services-products/investments/drawdown-pensions).

<sup>17</sup> Individual pensions are invariably DC, or personal, pensions. Some people may have individual stakeholder pensions, which are a type of personal pension.



- workplace pensions, set up by an employer, in which the employer generally makes a contribution to the employee's pension.

### 3.9 The different types of workplace pensions are:

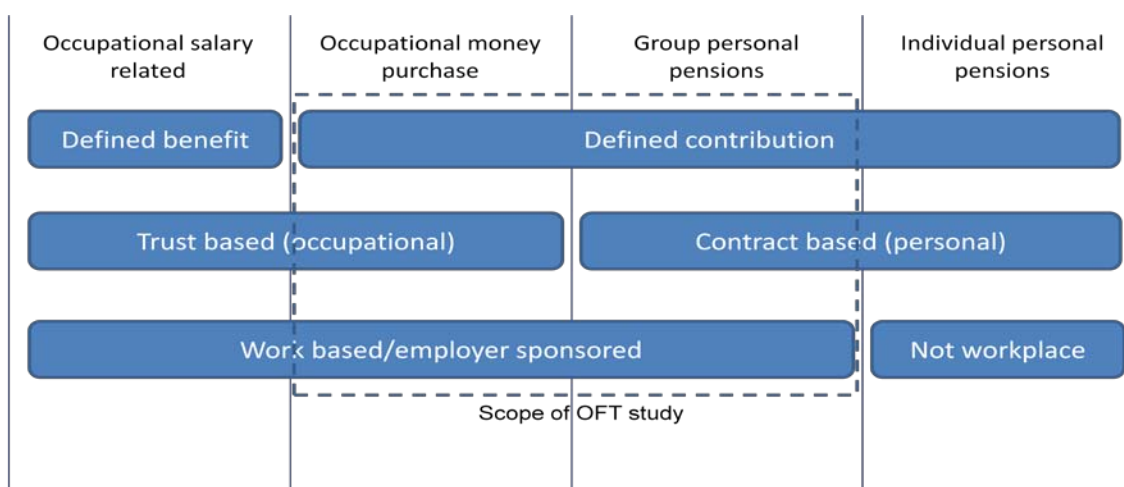
- DB schemes (also known as occupational salary related schemes) which promise the employee a certain income in retirement that is linked to their salary, years of service and the contributions made. Schemes may be linked to an individual's final salary or their average salary over their career. These schemes give an individual greater certainty over their income in retirement, leaving the investment risks of the scheme with their employer, and
- DC schemes are those in which the size of the pension pot accrued (and the consequential income in retirement) is linked to the contributions made by the individual and their employer in their working life, the costs of the scheme and the performance of the investments. The investment risks of the scheme fall to the employee and there is considerably less certainty about the income the employee will receive in retirement. These schemes are also referred to as occupational money purchase schemes, if they are trust based, or group personal pensions,<sup>18</sup> if they are contract based.

3.10 This market study is focused on DC workplace pensions, shown by the dotted line in the diagram below. These pensions are likely to be used by employers who are automatically enrolling their employees into a pension scheme.

---

<sup>18</sup> Some employers may have group stakeholder pensions, which are a type of personal pension.

**Figure 3.1: Pension schemes and the scope of this market study**



Source: OFT and ONS<sup>19</sup>

3.11 As illustrated in Figure 3.1, DC workplace pensions can be contract or trust based.

- Contract based schemes - sometimes referred to as workplace personal pension schemes are set up with a provider (often an insurance company) who runs the scheme and usually enters into a contract with each employee. The value or return on the work based personal pension scheme is linked to one or more underlying authorised funds. Employers may or may not involve their employees in selecting a pension provider, the design of the default investment strategy or in the ongoing management of the scheme. For the purposes of this report, these schemes will be referred to as 'contract based schemes'.
- Trust based schemes are set up by the employer with the responsibility for governing the scheme lying with a board of trustees. The trustees are the legal owners of the assets held in trust for the members and owe a fiduciary duty to the scheme's members. The administration and investment management of the trust may be outsourced to a single company who 'bundles' the administration and investment management services, or to several organisations which provide part of an 'unbundled' service (for

<sup>19</sup> ONS, 2013 Pension Trends. Available here: [www.ons.gov.uk/ons/dcp171766\\_313466.pdf](http://www.ons.gov.uk/ons/dcp171766_313466.pdf)

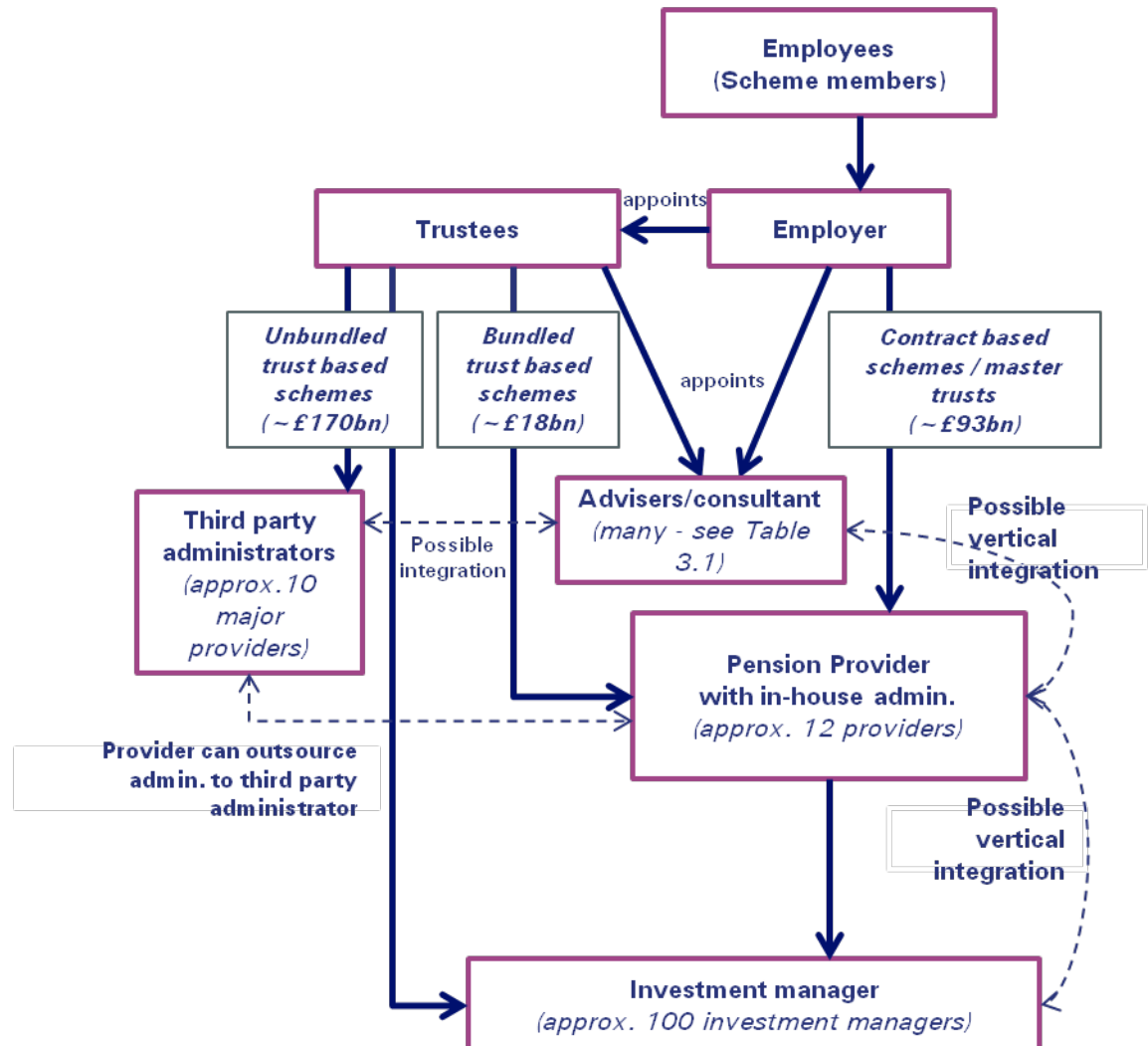
example, one organisation providing scheme administration, another providing investment management). Investment objectives and strategies are set by the trustees who may choose to invest with one or many investment managers. These schemes are known in regulatory terms as occupational schemes, but for the purposes of this study these schemes will be referred to as 'trust based schemes'.

- 3.12 Master trust is a term used for trust based schemes which are set up by a provider for more than one employer. Master trusts generally have more members than the average trust based scheme and, as a result, may benefit from economies of scale through shared administration and management costs.

## **The market for DC workplace pensions**

- 3.13 The DC workplace pensions market is complex, involving multiple players with differing roles on both the demand and supply sides of the market, as illustrated in Figure 3.2. In practice, a single company may undertake more than one role, or companies that are part of the same corporate group may take on various roles through the supply chain. The roles of each of the key players in the industry are described below.

Figure 3.2: Industry players



Source: OFT

## The role of the employer and trustees

3.14 The employer takes responsibility for setting up a workplace pension scheme for its employees. Once the scheme is set up the employer does not have any ongoing responsibility for monitoring the performance of the scheme.<sup>20</sup> If a trust based scheme has been

<sup>20</sup> Under AE, the duties for an employer include arranging a pension scheme, enrolling an employee into a pension scheme, managing opt outs, providing information to groups of employees, making employer contributions, maintain contributions to the pension scheme, keep records about their employees and the scheme used to comply with their duties and keep track of the ages and earnings of everyone who works for them at all times. More details can be found here: [www.thepensionsregulator.gov.uk/docs/pensions-reform-employer-duties-defining-workforce-v4.pdf](http://www.thepensionsregulator.gov.uk/docs/pensions-reform-employer-duties-defining-workforce-v4.pdf)

established, trustees owe a fiduciary duty to members which, in practice, means they should review the performance and administrative quality of the scheme.

## **The role of advisers and consultants**

3.15 The DC workplace pensions market is heavily intermediated. Pension providers have historically relied on corporate advisers to distribute products on their behalf. In 2012, approximately 77 per cent of the regular premiums invested into schemes were advised on by intermediaries.<sup>21</sup>

3.16 Advisers can help employers and trustees select a pension provider and design default investment strategies which employees will be enrolled into if they make no active choice of investment fund. Advisers can design the default scheme specifically for an employer, taking into account the demographics of the employer's workforce or, usually after a tendering exercise has been conducted, they may recommend a pension provider's 'off the shelf' default strategy from those available on the market. Advisers may also be active in negotiating better terms for an employer on their pension scheme once the scheme has been set up.

3.17 Advisers may be:

- Independent Financial Advisers (IFAs) who in the past were remunerated through commission from pension providers (who in turn recover this from members through higher charges) and fees paid by employers.<sup>22</sup> Smaller IFAs generally focus on providing advice to individuals and small firms, while larger IFAs and IFA networks will also provide advice to larger employers.
- Employee Benefit Consultants (EBCs) who advise employers on the range of schemes available and their suitability to the employer and employee as well as a range of other benefits available to

---

<sup>21</sup> Regular premiums are the contributions members make on an ongoing basis. They differ to single premiums which members make as a 'one off', for example if they receive some inheritance. More details can be found here: Mintel Occupational and Group Pensions, June 2013.

<sup>22</sup> Although the payment of new commission was banned in January 2013, there are grandfathering provisions for earlier commission based arrangements, see paragraph 3.19 for more information.

employees. They receive fees from employers in return.

3.18 In some cases, advice to employers on pensions may also be provided by banks, accountancy firms and legal advisers.

3.19 As illustrated in Table 3.1, until recently, there has been a division between the smaller employers served by smaller commission-based IFAs and the larger fee based EBCs, which tended to focus on the larger employers with trust based schemes. However, on 31 December 2012, the FSA implemented a number of changes following its Retail Distribution Review (RDR). The new rules require advisers to set out clearly the charges imposed for their services and prohibit them explicitly from receiving commission from providers for the distribution of their products. The RDR changes appear to have led some advisers to seek new ways of earning fees for their services (to compensate for income lost as a result of not being able to earn new revenue streams from commission) and are moving into the administration of unbundled schemes, while others are moving into offering investment products themselves.<sup>23</sup>

---

<sup>23</sup> The FCA has recently undertaken a review of the effect of RDR and has found that the majority of firms have made progress and are willing to adapt to the new rules but that there were still issues to resolve. The review is the first of three planned over the next year to assess what progress advisory firms are making to meet the new RDR rules.

**Table 3.1: The different types of intermediary**

Type of intermediary	Examples	Fee based?	Commission based? (Pre-RDR)
EBCs	Aon Hewitt Mercer Towers Watson	Yes	
Audit Consultancies	Deloitte Ernst and Young KPMG PWC	Yes	
Corporate IFAs	BlueFin Hargreaves Lansdown Punter Southall Towergate	Yes	Yes
Smaller IFAs	Many	Yes	Yes
Others	Barclays Bank Close Brothers St James' Place	Yes	Yes

Source: OFT and Spence Johnson

## Pension providers

3.20 Pension providers<sup>24</sup> manage bundled trust and contract based DC schemes. Providers have responsibility for a range of scheme features that will affect the value for money of the scheme including:

- undertaking the marketing of those schemes to employers (usually via intermediaries)
- administering the scheme (unless it is outsourced to a third party administrator), and
- selecting and reviewing the performance of the funds which will appear on their investment platforms.

3.21 Pension providers that offer DC contract and bundled trust based schemes tend to be large insurance companies. These insurance companies have governance processes in place to review fund and administration performance. Whilst providers registered with the FCA

<sup>24</sup> Pension providers can also have internal investment managers.

should be guided by the FCA's Treating Customers Fairly (TCF) principles, this does not give rise to a fiduciary duty to manage the scheme in the interests of all members.<sup>25</sup>

3.22 Alternatively, pension providers can be multi-employer master trusts which have a single trustee board with a fiduciary duty to manage the scheme in the interest of members. Master trust trustees can be appointed by members and employers or, if the master trust is part of a wider group, can put in place professional trustees that are appointed and paid for by the provider.

### **Third party administration**

3.23 Third party administrators can administer unbundled schemes on behalf of trustees and contract based schemes on behalf of pension providers. The roles of third party administrators include:

- enrolling members
- recording members' investment decisions
- collecting contributions
- managing accounts and accessing savings
- passing funds to the fund administrator in accordance with member wishes, and
- communication to members.

3.24 Several pension providers have recently outsourced the administration of schemes to a third party. Friends Life, Legal and General, National Employment Savings Trust (NEST) have all outsourced at least part of the administration to Diligenta.<sup>26</sup> NOW: Pensions uses Xafinity Paymaster to administer their schemes.<sup>27</sup>

---

<sup>25</sup> It is possible that some providers operate as trustees, in which case they would owe a fiduciary duty to the beneficiaries of the schemes.

<sup>26</sup> See here for more information on Diligenta and Friends Life partnership [www.diligenta.co.uk/diligenta/infopool.nsf/html/about-diligenta](http://www.diligenta.co.uk/diligenta/infopool.nsf/html/about-diligenta). See here for more information on Diligenta and Legal and General partnership [www.actuarialpost.co.uk/article/friends-life-completes-transfer-of-operations-to-diligenta-2118.htm](http://www.actuarialpost.co.uk/article/friends-life-completes-transfer-of-operations-to-diligenta-2118.htm)

See here for more information on Diligenta and NEST partnership [www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/tcs-factsheet,PDF.pdf](http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/tcs-factsheet,PDF.pdf)

<sup>27</sup> See here for more information on Xafinity and NOW pensions partnership [www.xafinity.com/uploads/files/partnership-with-atp\\_final.pdf](http://www.xafinity.com/uploads/files/partnership-with-atp_final.pdf)



## Investment management

3.25 Investment management can be provided by the investment arm of a pension provider or an external investment management company. Nine out of the ten largest providers of bundled trust and contract based pensions that responded to our request for information are vertically integrated with in-house investment managers and offer their own funds to pension savers among other options.

3.26 Investment managers choose the mix of asset classes that will best meet the objectives of the investment strategy. The pension providers (or trustees) remain responsible for monitoring the performance of the funds and for making decisions relating to moving investments to other funds elsewhere. The investment manager is paid an investment management fee for managing the funds. They will also generally pass on transaction costs when assets are bought and sold. These costs are usually taken directly out of the funds' assets. (See Chapter 6 for more details on costs and charges).<sup>28</sup>

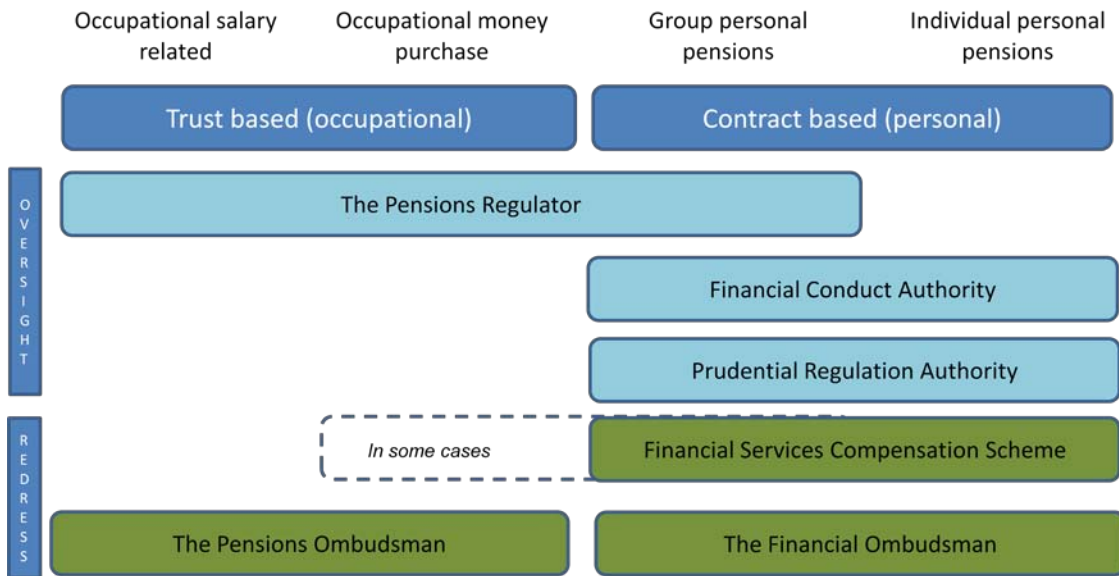
## Regulatory oversight

3.27 Numerous public bodies play a role in developing pension policy, regulating the firms that are active in the market and providing redress to consumers where required. Figure 3.3 below sets out the key bodies responsible for these different activities.

---

<sup>28</sup> [www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf](http://www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf)

**Figure 3.3 Public sector responsibilities in the DC workplace pension sector**



Source: OFT

## The role and powers of the Pensions Regulator

3.28 In exercising its statutory functions, TPR has the main objective of protecting benefits under work based pensions schemes and promoting good administration. TPR fulfils this duty by issuing codes and guidance on aspects of work place pension schemes (although its ability to act formally when guidance is not sufficient is greater when the problem is with a trust based scheme). The regulator has a range of options for dealing with trust based schemes. It has powers to:

- issue notices and orders
- recover unpaid contributions
- prohibit trustees who are not fit and proper
- impose fines where it finds a breach (for example, where the security of a member's benefits has been jeopardised), and
- prosecute certain offences in the criminal courts.

3.29 The regulator aims to regulate according to the risks in the market by 'educating, enabling and enforcing' through codes, guidance and support wherever possible, and using enforcement action only as a last resort.<sup>29</sup> When the regulator does enforce against breaches of behaviour, principles and statutory responsibilities set out in its Code of Practice, it generally does on a case-by-case basis. TPR is bound by legislation and does not have rule making ability, as the FCA does.

3.30 TPR has fewer options to intervene directly on contract based pension schemes, where regulatory responsibilities are shared with the FCA. In 2012, the National Audit Office (NAO) looked at the regulation of DC pension schemes and found that TPR may not have been given sufficient statutory powers to fulfil its objectives regarding contract based schemes.<sup>30</sup>

## **The role and powers of the Financial Conduct Authority**

3.31 The FCA regulates firms and individuals that promote, arrange, or provide contract based DC schemes. The FCA can investigate the conduct of registered firms, enforce rules and regulations, and make new rules as required. In doing so, firms authorised by the FCA must adhere to the FCA's TCF principles which requires firms to focus on six outcomes for consumers.

3.32 The FCA may take enforcement action where firms have failed to comply with their rules (for example, around Conduct of Business) or their Principles (for example, around Treating Customers Fairly which requires firms to focus on six outcomes for consumers), particularly where there is a significant risk to consumers. The FCA regulates through regular assessments of firms' conduct and varies the intensity of these assessments based on the nature and size of the firm.<sup>31</sup> Many of the investment products used by DC schemes will be regulated by the FCA. The FCA is also responsible for the prudential regulation of financial services firms, like investment managers, which are not supervised by the Prudential Regulation Authority (PRA).

---

<sup>29</sup> An overview of the regulator's powers can be found here: [www.thepensionsregulator.gov.uk/about-us/our-powers.aspx](http://www.thepensionsregulator.gov.uk/about-us/our-powers.aspx)

<sup>30</sup> NAO Regulating defined contribution schemes 2012, available here: [www.nao.org.uk/wp-content/uploads/2012/07/1213466.pdf](http://www.nao.org.uk/wp-content/uploads/2012/07/1213466.pdf)

<sup>31</sup> More information about the FCA's regulatory approach can be found here: [www.fca.org.uk/about/what/regulating/how-we-supervise-firms](http://www.fca.org.uk/about/what/regulating/how-we-supervise-firms)

3.33 In principle, the FCA could take action against a poor value for money contract based DC pension under the treating customers fairly outcomes. However, to the extent that regulation may be directed at specific actions of companies, or at specific developments in the market, it may not be best suited for tackling value for money. That is because, as noted throughout this report, many of the value for money risks we have identified result less from specific actions in the market, and more from the consequences of inaction over a prolonged period of time. We do however note that under the FCA, there is a pension team in place and greater scope to taking a proactive approach to ensure DC workplace pensions provide ongoing value for money for savers.

## **The role of the Prudential Regulation Authority**

3.34 The PRA is a subsidiary of the Bank of England responsible for the prudential regulation and supervision of deposit takers, insurers and major investment firms.<sup>32</sup> The objective of the PRA is to promote the safety and soundness of PRA-authorized persons, including firms active in the pensions market. The companies that provide contract and bundled trust based schemes tend to be regulated by the PRA which safeguards against systemic risk in the market. Providers of master trusts are not currently subject to prudential regulation.

## **Other redress mechanisms**

3.35 Where a consumer has a complaint about a pension that has not been dealt with by the company concerned, they may have a right to complain to one of the following independent ombudsmen which will investigate that complaint and arbitrate on the concerns identified:

- the Pensions Ombudsman will investigate complaints relating to maladministration of trust based schemes. It is funded by a grant-in-aid from the DWP, collected by TPR as a levy on pension schemes, and

---

<sup>32</sup> [www.bankofengland.co.uk/pr/Pages/publications/designationinvestmentfirms.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/designationinvestmentfirms.aspx). The PRA only prudentially supervises certain 'designated' major investment firms

- the Financial Ombudsman will investigate complaints of mis-selling of financial products, including contract based pensions. It is funded by a levy on businesses collected by the FCA.

3.36 In addition, the Financial Services Compensation Scheme (FSCS) can pay compensation if a firm that is authorised by the FCA is unable, or is likely to be unable, to meet claims against it. Long-term insurance contracts taken out with a UK insurer are normally protected by the FSCS. Policies bought from UK insurers by trustees of UK-based pension schemes are also likely to be protected. However, the rules for claiming compensation are complex and not all types of employers, schemes and investment products are covered by these arrangements. For example, as the FSCS was set up to assist private individuals and small firms, larger employers might not be able to make a claim. As a result, it can be difficult for trustees and employers to understand when they are choosing a pension scheme and making investments on behalf of employees.

## **Savings trends and recent policy developments**

3.37 The OFT has identified three savings trends and recent policy developments that are changing the characteristics of the DC workplace pensions sector:

- falling numbers of workplace pension savers in recent years
- a decrease in DB and increase in DC pension schemes, and
- growing concerns about small pots and small pension schemes.

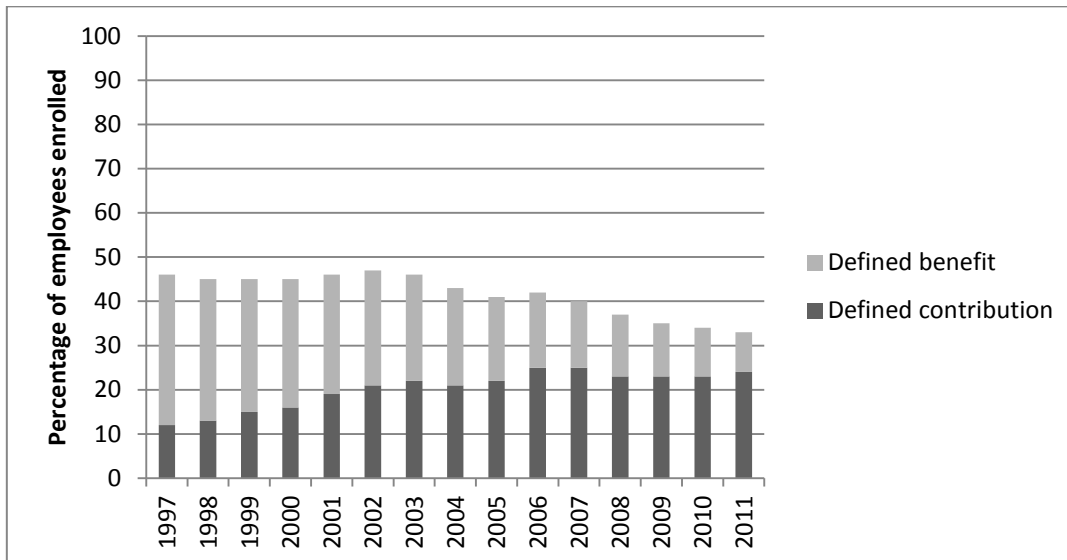
### **Falling numbers of workplace pension savers**

3.38 The number of employees saving into workplace pension schemes has been falling in recent years. As illustrated in Figure 3.4, in 2011 only one third of private sector employees were contributing to a pension scheme, compared to 46 per cent in 1997. The DWP estimates that, as a result, 40 per cent (11 million) of people aged between 22 and the state pension age are not currently saving sufficiently to achieve their expected income in retirement.<sup>33</sup>

---

<sup>33</sup> The DWP, *Reinvigorating workplace pensions*, page 7.. Available at: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214603/reinvigorating-workplace-pensions.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214603/reinvigorating-workplace-pensions.pdf)

**Figure 3.4: Private sector employees enrolled in a work based pension**



Source: OFT from Office of National Statistics (ONS) data

3.39 The level of workplace pension saving has been a long-standing policy challenge for successive governments. In 2002, the previous Government set up a Pensions Commission to review the regime for UK private pensions and long term savings. In 2005, the Commission recommended the creation of a National Pension Savings Scheme (NPSS) into which employees would be automatically enrolled but with the right to opt out.<sup>34</sup>

3.40 In 2012, the Government started the implementation of the Pension Commission's recommendation that employers automatically enrol employees into a pension scheme. AE requires employers to enrol their employees into a workplace pension scheme. The key difference between the Pension Commission's recommendation and AE is that whilst the Commission envisaged there being one default pension provider, now AE requires employers to actively choose a pension provider. As a result, employers now play a pivotal role in driving competition by choosing a workplace pension provider.

3.41 The key features of AE are:

- employers are required to enrol any employee earning more than £9,480 annually into a workplace pension scheme

<sup>34</sup> The executive summary of the Pension Commission's second report is available here: [http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/30\\_11\\_05\\_exec\\_summ.pdf](http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/30_11_05_exec_summ.pdf)

- employees can opt out of the scheme once they have been enrolled but will be re-enrolled every three years
- once roll out is complete, contributions will eventually be set at a minimum level of eight per cent of qualifying earnings,<sup>35</sup> with employers contributing three per cent, employees four per cent and a tax rebate providing a further one per cent contribution<sup>36</sup>
- roll out will occur over the next five years (starting with the largest employers) so that by 2018 all employers will have set up schemes for their eligible employees, and
- AE is expected to increase the number of individuals enrolled in DC workplace pension schemes by six to nine million.<sup>37</sup>

3.42 As illustrated in Figure 3.5, AE will lead to approximately 1.2 million employers entering the DC workplace pension sector and set up AE schemes for their employees. It is estimated that the majority of these employers (99 per cent) will be Small and Medium employers (SME) (although the majority of employees that will be enrolled will work for large firms).<sup>38</sup> The DWP estimates that 65 per cent of SMEs will make use of the government-backed saving scheme, NEST, and is proposing changes to make this scheme more accessible to employers.<sup>39</sup> In August 2013, the DWP published research showing that the average opt out of public and private sector employees in their study was only nine per cent.<sup>40</sup> However, the DWP's research was focused on large employers and the opt out rate may increase when smaller employers with employees on lower earnings are eligible for AE.

---

<sup>35</sup> Qualifying earnings include salary, wages, commission, bonuses, overtime and statutory sick pay.

<sup>36</sup> Minimum contribution rates are being phased in so that the eight per cent floor will be achieved by 1 October 2018: [www.thepensionsregulator.gov.uk/employers/phasing.aspx](http://www.thepensionsregulator.gov.uk/employers/phasing.aspx).

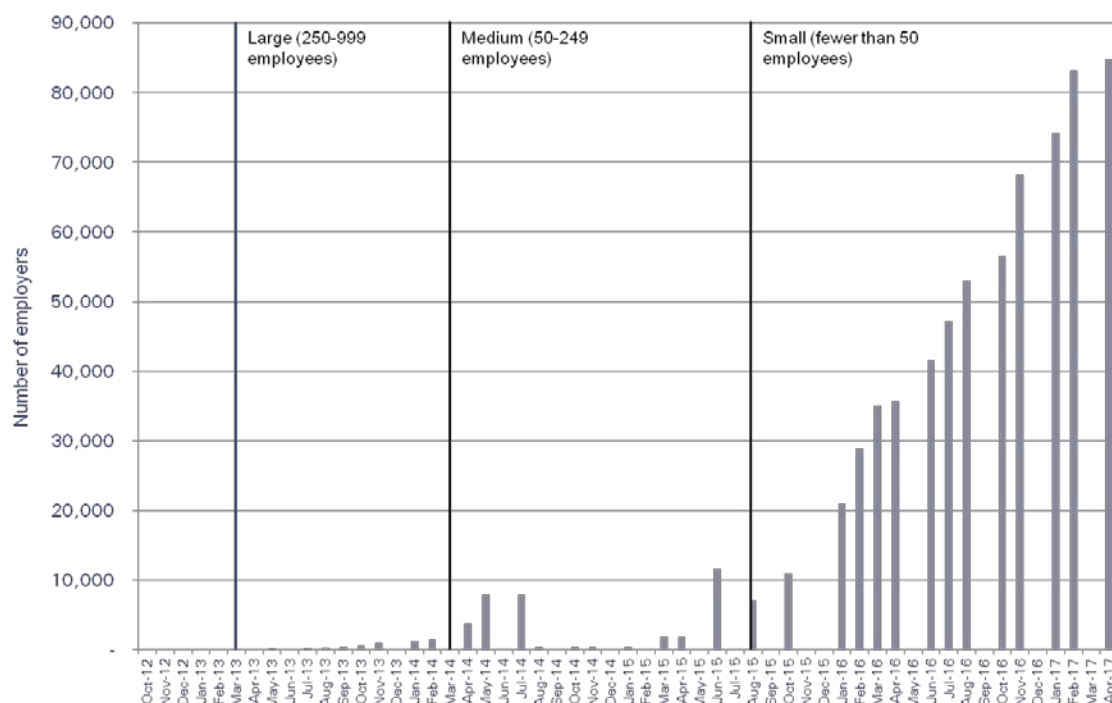
<sup>37</sup> [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/223031/wpr\\_digest\\_0712.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223031/wpr_digest_0712.pdf)

<sup>38</sup> DWP, Supporting AE. The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST, 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf)

<sup>39</sup> DWP, Supporting AE. The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST, 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf)

<sup>40</sup> DWP, AE opt out rates: findings from research with large employers, 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/227039/opt\\_out-research-large-employers-ad\\_hoc.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/227039/opt_out-research-large-employers-ad_hoc.pdf)

**Figure 3.5: Number of employers by AE staging dates.**



Source: The DWP<sup>41</sup>

Note: This series shows the staging profile for employers as at April 2012 (estimated to be 1.2 million) after adjusting for employers that cease to trade before they reach their AE duty start date.

## Decrease in DB and increase in DC pension schemes

3.43 In addition to the number of workplace pension savers being set to increase over the next five years, the type of pension schemes into which members save is set to continue to shift from DC schemes to defined contribution schemes. Since 2003, DC schemes have overtaken DB schemes as the savings vehicle most commonly offered to new employees. The percentage of employees enrolled in DB pension schemes in 2011 was 28 per cent against 46 per cent in 1997. In contrast, the proportion of employees with DC workplace pensions increased from 10 per cent in 1997 to 17 per cent in

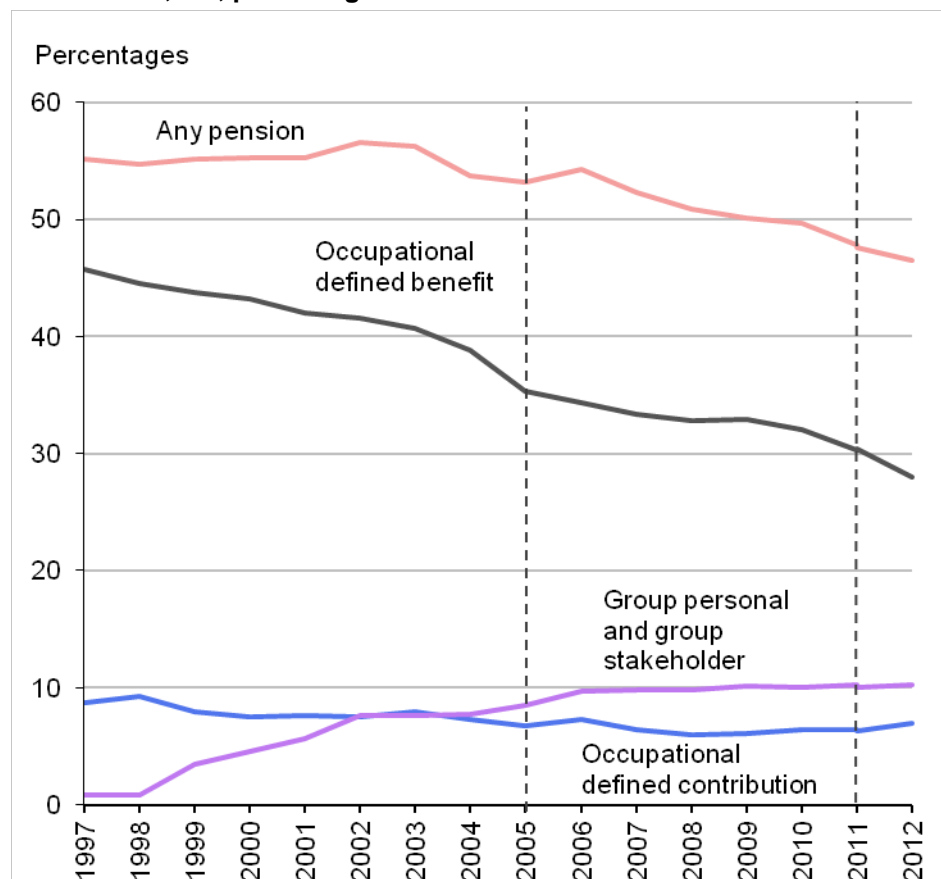
<sup>41</sup> DWP, Supporting AE The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST, 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf)



2011.<sup>42, 43</sup> The trend for saving into DC rather than DB workplace pension schemes is likely to continue as employers have to carry significantly less liability for pension outcomes.

3.44 Further, as illustrated in Figure 3.6, there has been an increase in the percentage of employees using contract (group personal and group stakeholder) schemes as opposed to trust based (occupational defined contribution) schemes in recent years, a trend that is likely to continue in the future as a result of employers' perception that contract based schemes are less costly for employers to set up and administer.<sup>44</sup>

**Figure 3.6: Proportion of employees with workplace pensions: by type of pension, 1997 to 2012, UK, percentages**



<sup>42</sup> This is broadly consistent with Figure 3.6, which only shows the proportion of private sector employees enrolled in a workplace pension.

<sup>43</sup> ONS, 2013 Pension Trends. Available here: [www.ons.gov.uk/ons/dcp171766\\_313466.pdf](http://www.ons.gov.uk/ons/dcp171766_313466.pdf)

<sup>44</sup> NAPF, Regulatory differences between occupational and workplace personal pensions. Available here: [www.napf.co.uk/PolicyandResearch/DocumentLibrary/~ /media/Policy/Documents/0173\\_Regulatory\\_differences\\_between\\_occupational\\_and\\_workplace\\_personal\\_pensions\\_A\\_NAPF\\_response\\_to\\_a\\_DWP\\_consultation.ashx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~ /media/Policy/Documents/0173_Regulatory_differences_between_occupational_and_workplace_personal_pensions_A_NAPF_response_to_a_DWP_consultation.ashx)

Source: ONS<sup>45</sup>

## Growing concerns about small pots and small pension schemes

3.45 Whilst the expected increase in workplace pension saving is a positive trend, there is a risk that many individuals may find themselves paying into a number of different workplace pension pots, some quite small, because on average people change jobs 11 times in their working lives.<sup>46</sup> Few individuals roll-over or consolidate their pensions into one scheme when they change jobs, even when this option is available.<sup>47</sup> Small pots may therefore be forgotten about, or may not grow as significantly in value because of the impact of charges.

3.46 To overcome some of these concerns, in April 2013 the DWP set out plans to consolidate an individual's separate pensions into one scheme (so-called 'pot follows member' proposals) where the individual's pension pot is worth less than £10,000.<sup>48</sup> The DWP are continuing to work with the industry as well as other government departments to develop detailed options for this automatic transfer process.

3.47 In addition to the prevalence of small pots, many scheme members and assets are saving into smaller schemes.<sup>49, 50</sup> Around 80 per cent of memberships and assets in bundled trust based and contract based schemes are in small and medium schemes with fewer than 1,000 memberships.

---

<sup>45</sup> ONS, 2012 Annual Survey of Hours and Earnings: Summary of Pension Results, 2013. Available here: [www.ons.gov.uk/ons/dcp171778\\_299511.pdf](http://www.ons.gov.uk/ons/dcp171778_299511.pdf)

<sup>46</sup> Johnson, Yeandle and Boulding, DWP, October 2010.<sup>46</sup> DWP, Making AE work, October 2010. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214585/cp-oct10-full-document.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214585/cp-oct10-full-document.pdf)

<sup>47</sup> Roll-overs or consolidation of different pensions may be possible but the Pensions Institute reports that 80 per cent of individuals do not transfer their pension pots to new workplace schemes after they change jobs. Caveat Vendor, page 7.

<sup>48</sup> DWP, Automatic transfers: consolidating pension savings, April 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/191697/automatic-transfers-consolidating-pension-savings.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191697/automatic-transfers-consolidating-pension-savings.pdf)

<sup>49</sup> TPR uses the following size classification of schemes: Micro (fewer than 12 members), Small (12 - 99 members), Medium (100 - 999 members), and Large (1000 members or more).

<sup>50</sup> The DWP uses the following size classifications for employers: Small (49 employees or fewer), Medium (50 - 249 employees), and Large (250 employees or more). See: [www.dwp.gov.uk/docs/auto-key-facts-enrolment-booklet.pdf](http://www.dwp.gov.uk/docs/auto-key-facts-enrolment-booklet.pdf)

**Table 3.2: Cumulative distribution of memberships and assets in bundled trust and contract based schemes**

Scheme size (members)	Fewer than 10	Fewer than 50	Fewer than 250	Fewer than 1,000	Fewer than 5,000	Fewer than 10,000
Members	14%	38%	60%	79%	88%	92%
Assets	18%	42%	63%	80%	88%	94%

Source: OFT

Notes: This table shows the cumulative proportion of memberships and assets in bundled trust and contract based schemes with fewer than 10, 50, 250, 1,000, 5,000, and 10,000 memberships. It is based on information submitted by a subset of providers that provided detailed responses. In 2013, these providers jointly account for 98 per cent of schemes, 85 per cent of memberships, and 93 per cent of assets in the OFT sample.<sup>51</sup>

3.48 Based on data from providers, at least three-quarters of the schemes covered by the OFT's survey are small (following TPR's size classification of schemes, small schemes are those with 99 or fewer members). There are at least 20,000 small bundled trust schemes and at least 100,000 small contract based schemes. The implications of the larger number of trust based schemes are discussed in Chapter 7.

---

<sup>51</sup> As discussed in Chapter 4 on Supply, it is difficult to gather consistent information on overall market size of the DC workplace pensions market. The OFT sample does not cover the full market, as some market players did not submit their data to us, but the OFT sample is likely to be the most comprehensive available estimate for contract based and bundled-trust based schemes.

## **4 THE SUPPLY SIDE**

### **Introduction**

4.1 In order for competition to drive good outcomes for all savers in the workplace DC pension market providers must compete on the key aspects of value for money for pension scheme members.

4.2 This chapter looks at:

- The structure of the supply side of the market.
- How the characteristics of the pensions market may affect competition and market outcomes.
- How pension providers compete and how this aligns with the key elements of scheme value for money.

### **Market structure**

4.3 As outlined in Chapter 3, the DC workplace pension market has a long supply chain. There are two key reasons for this:

- pensions are a complex product which makes decisions on value for money difficult. This complexity combined with a weak buyer side of the market where employers, who make the key decisions about pensions on behalf of their scheme members, often lack the capability and/or the incentive to assess value for money leads many employers to use the help of advisers or trustees to help to overcome these challenges, and
- the types of product favoured by employers has evolved over the past 20 years from trust based schemes - which were more popular with employers in the 1990s and early 2000s - to contract based schemes which became more popular in 2000s and early 2010s. There are now signs that many employers due to set up new schemes under AE are likely to choose a contract based scheme or newer master trust products. As set out at Chapter 3, the supply

chain for each type of product looks slightly different and adds to the complexity of the supply side of the market.

## Market size

4.4 It is difficult to gather credible information on overall market size. The OFT uses DC workplace pension AUM (AUM) as a measure of market size. In 2012, Spence Johnson,<sup>52</sup> an industry consultant, estimated that total DC workplace pension scheme AUM are worth approximately £276 billion in 2013,<sup>53</sup> with around:

- £93 billion in contract based schemes
- £183 billion in trust based schemes, of which £13 billion are in bundled trust based schemes and £170 billion are in unbundled trust based schemes.<sup>54</sup>

4.5 On the basis of the data that the OFT gathered we believe that the Spence Johnson estimate of £93 billion in contract based schemes is a slight under-estimate. The 11 providers that responded to the OFT's questionnaire with information on AUM, currently hold approximately £93 billion of assets in contract based schemes. However, since at least two other providers did not supply data to the OFT, we believe the true volume of AUM is likely to be higher as we estimate the OFT's sample accounts for approximately 92 per cent of AUM in Group Stakeholder and GPP schemes.<sup>55</sup>

4.6 Similarly, based on data from 11 major providers, we have identified £18 billion assets in bundled trust based schemes. However, since at least two providers did not provide data to the OFT, the overall size of the bundled trust based market is likely to be slightly higher.

---

<sup>52</sup> Spence Johnson, Defined Contribution Market Intelligence, 2013.

<sup>53</sup> The ONS estimated that the assets in DC schemes were worth £386 billion. In Spence Johnson's view, the discrepancy occurs because the ONS data includes assets in decumulation.

<sup>54</sup> This does not include assets currently in master trusts.

<sup>55</sup> The OFT did not receive responses from at least two providers in the bundled-trust and contract based DC workplace pensions industry. Using public information, the OFT estimates that non-respondents have at least 12,000 Group Stakeholder and GPP schemes with at least 60,000 memberships in December 2012. As a very rough estimate of the non-respondents' AUM, the OFT multiplied these by the relevant average assets per (group stakeholder, and GPP) scheme in the OFT sample. This gives a rough estimate of £7.54bn, which would imply that the OFT sample covers approximately 92 per cent of AUM in Group Stakeholder and GPP schemes in the industry.

4.7 The majority of assets in trust based schemes are in unbundled trust based schemes. The OFT did not gather information for unbundled trust schemes, as these are supplied in a more complex way by multiple providers (for example, some trustees for unbundled trust based schemes may perform administration in-house, whilst others may outsource it to third-party administrators) and data was not readily available.

## Market players

4.8 The majority of contract and bundled trust based workplace pension schemes in the UK are provided by large insurance companies, including Aegon, Aviva, Friends Life, Legal and General, Prudential, Scottish Life, Scottish Widows, Standard Life, and Zurich among others. In addition to this there are a number of prominent providers of bundled trust and contract based schemes that are not insurance companies, for example, BlackRock, Fidelity, and HSBC.

4.9 A number of master trusts have recently entered the pension market in response to AE. TPR states that there are 44 master trusts established in the UK as at 2012.<sup>56</sup> As many of them have only recently entered the market, they have not built up a significant level of UK pensions AUM. Some of the larger master trusts include:

- NEST – it was set up with government backing to ensure employers of low paid employees would have access to a pension scheme. NEST has a Public Service Obligation to accept any employer (and qualifying employee) and offer them the same investment option and level of charges. This includes smaller employers whose employees are likely to have lower earnings, a lower appetite for risk and lower financial literacy. NEST's objective is to create a low charge<sup>57</sup> and lower-risk default investment strategy<sup>58</sup> business model,

---

<sup>56</sup> TPR, DC trust: a presentation of scheme return data, 2013. Available here:

[www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

<sup>57</sup> NEST website. NEST does not charge a fee to employers and its charges to savers are equivalent to 0.5 per cent AMC. Available here:

[www.nestpensions.org.uk/schemeweb/NestWeb/public/NESTforEmployers/contents/great-value.html](http://www.nestpensions.org.uk/schemeweb/NestWeb/public/NESTforEmployers/contents/great-value.html)

<sup>58</sup> NEST, Developing and delivering NEST's investment approach, 2012. Available here:

[www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Developing-and-delivering-NESTs-Investment-Approach,PDF.pdf](http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Developing-and-delivering-NESTs-Investment-Approach,PDF.pdf)

- NOW: Pensions – a new entrant to the UK market which is backed by a large Danish pension provider, ATP,
- The People's Pension – a master trust set up by B&CE, a not-for-profit organisation that has roots in supplying employee benefits to the UK construction industry, and
- A number of master trusts set up recently by insurance companies – including BlackRock, Fidelity, Legal and General, Standard Life, and Zurich as well as a master trust set up by an advisory firm, Xafinity.

4.10 In unbundled trust based schemes, the administration and investment management services are supplied by separate companies:

- Investment management services for DC workplace assets are provided by firms which include Baillie Gifford, BlackRock, Invesco Perpetual, JP Morgan AM, Legal and General AM, Schroders, and Standard Life Investment.<sup>59</sup> Some of these investment management firms are third party investment-only managers, whilst others are integrated or part of the same corporate group with bundled trust and contract based pension providers.
- There are also a number of providers of third party administrators which provide record keeping and communication services for unbundled schemes. A survey by Pensionsworld lists the leading third party administrators by number of clients of administration only services as Capita Hartshead, Jardine Lloyd Thompson Benefit Solutions, Mercer, and Xafinity.<sup>60</sup>

## **Market shares and concentration**

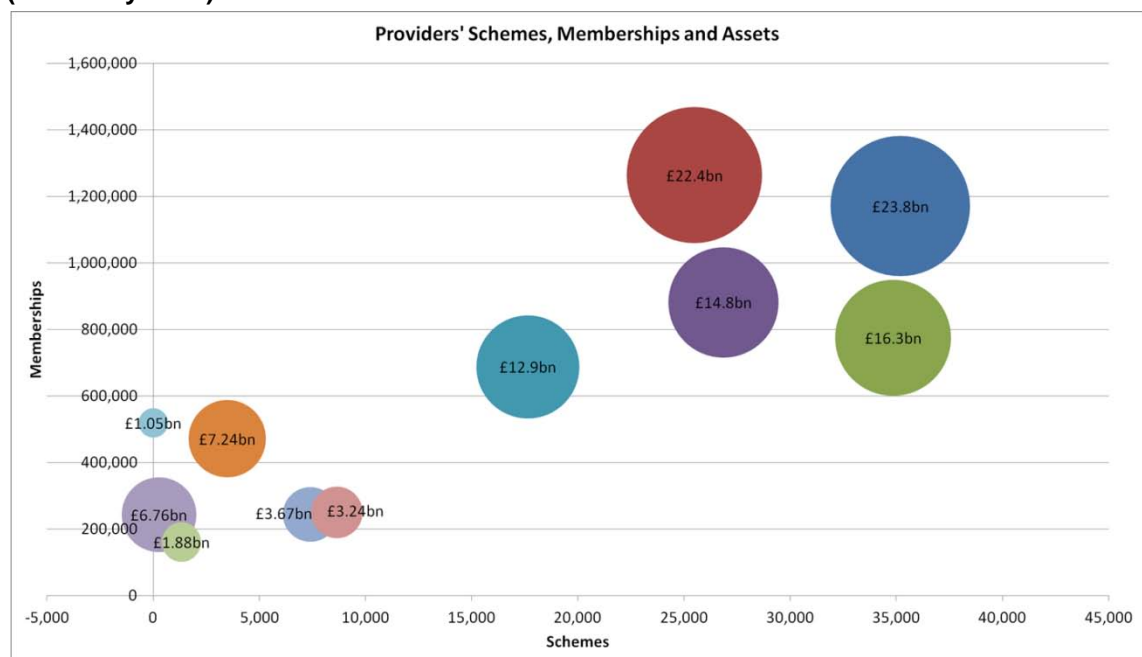
4.11 The OFT has not considered it necessary or practical to carry out a detailed market definition exercise for the purpose of this study. However, it has used the data it has been able to gather during the course of its study to estimate shares of supply and concentration of the contract and bundled trust based sectors.

<sup>59</sup> Spence Johnson, Defined Contribution Market Intelligence, 2013.

<sup>60</sup> Pensionsworld survey. Available here: [www.pensionsworld.co.uk/pw/files/Survey\\_Table1\\_p32.jpg](http://www.pensionsworld.co.uk/pw/files/Survey_Table1_p32.jpg)

4.12 Figure 4.1 below shows, using OFT data, the number of schemes, number of members and the value of assets for 11 major pension providers for trust and contract based schemes. In the Figure, the size of each circle represents each provider's total volume of AUM with the bottom axis showing the number of schemes and the vertical axis showing the number of memberships.<sup>61</sup>

**Figure 4.1: Pension providers by number of schemes, memberships and assets<sup>62</sup> (1 January 2013)**



Source: OFT analysis based on responses from providers

4.13 Figure 4.1 shows that the provision of contract and bundled trust based schemes is relatively concentrated, with four large providers holding the majority of schemes, assets and memberships. The largest four providers account for approximately 68 per cent of the total AUM in the OFT's sample, 76 per cent of schemes and 61 per cent of memberships.<sup>63</sup>

<sup>61</sup> The OFT did not receive responses from at least two providers in the bundled-trust and contract based DC workplace pensions industry. Using public information, the OFT estimates that non-respondents have at least 13,000 DC schemes with at least 170,000 memberships in December 2012. See [www.pensionsworld.co.uk/pw/article/survey-dc-schemes-12321941](http://www.pensionsworld.co.uk/pw/article/survey-dc-schemes-12321941). As a very rough estimate of the non-respondents' AUM, the OFT multiplied these by the relevant average assets per (bundled-trust, group stakeholder, and GPP) scheme in the OFT sample. This gives a rough estimate of £7.63bn, which would imply that the OFT sample covers approximately 94 per cent of AUM in the bundled-trust and contract based DC workplace pensions industry.

<sup>62</sup> This Figure shows the number of schemes, memberships, and AUM for 11 major providers as at 1 January 2013.

<sup>63</sup> The OFT did not receive responses from some providers in the bundled-trust and contract based DC workplace pensions industry. The OFT does not know the size of these providers' DC workplace pensions business. It is possible that those that have not responded could be large enough to supplant one of the top four providers in the OFT sample, so the Figures above should be interpreted with caution.

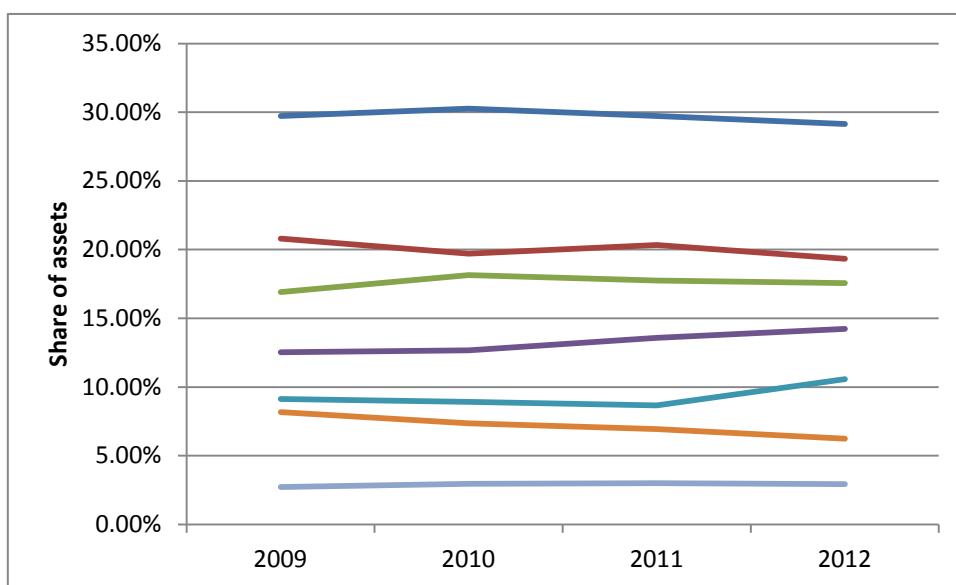


4.14 The market shares of master trusts providers are relatively low. Master trusts account for 0.5 per cent of assets, and 1.6 per cent of memberships in the OFT's sample.<sup>64</sup> This is because master trusts entered the DC sector relatively recently.<sup>65</sup>

4.15 Providers' market shares appear to be relatively static over time.

Figure 4.2 shows that the shares of the AUM for the seven providers<sup>66</sup> that submitted historic data to the OFT did not change significantly in the four years from 2009 and 2012. For this subsample of providers, no provider's market share, in terms of AUM had changed by more than two per cent over the period.<sup>67</sup>

**Figure 4.2: Shares of AUM in 2009 and 2012 for seven providers<sup>68</sup>**



<sup>64</sup> These estimates do not include data from all master trust providers, though this is not likely to increase substantially even if these are included.

<sup>65</sup> Entry of master trusts is discussed in more detail in paragraph 4.27 below.

<sup>66</sup> In 2013, these seven providers jointly account for 78 per cent of schemes, 67 per cent of memberships, and 75 per cent of assets in the OFT sample.

<sup>67</sup> This change is likely to be an overestimate of the true change in share of supply for contract and bundled trust schemes as it is taken from a subsample.

<sup>68</sup> This Figure shows the market shares of seven providers out of the OFT sample, as a proportion of the combined assets of those seven providers.

## Barriers to entry

4.16 We have also considered the extent to which there are barriers to entry in the market. We have identified three potential sources of such barriers:

- economies of scale, which arise from the way that costs are structured within providers' business models
- potential regulatory barriers, and
- providers' reputation.

4.17 We have also considered the extent to which potential barriers are actually preventing market entry.

### Economies of scale

4.18 Many providers have told the OFT that profit margins are low in the pensions market and that achieving satisfactory return on capital employed is a medium to long term objective.

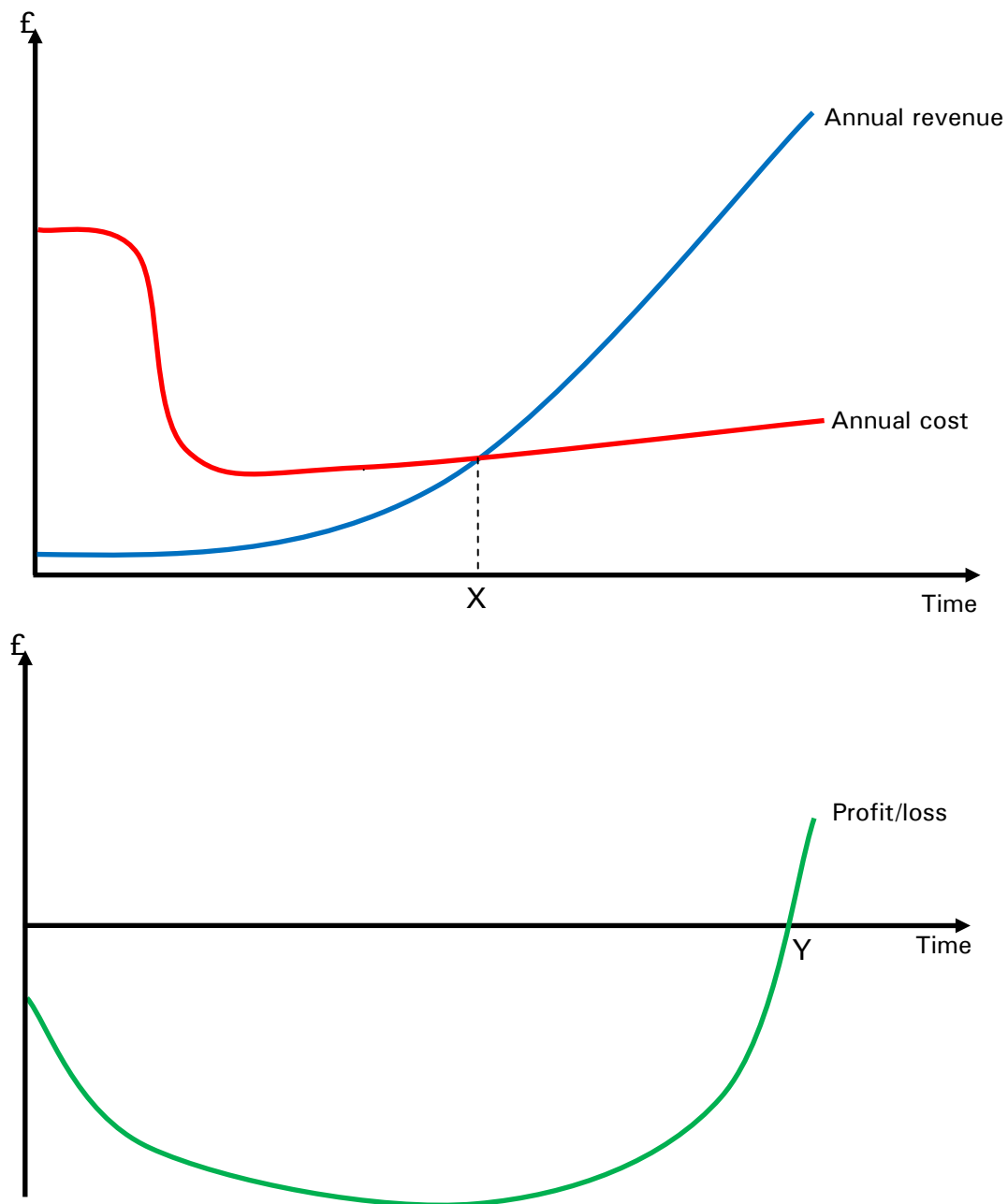
4.19 At the level of an individual scheme, providers can expect to make losses for quite some time before breaking even. Providers incur significant costs upfront,<sup>69</sup> but revenue from AMC is low initially and increases over time as AUM accumulate. Figure 4.3 shows that, for a typical scheme, annual revenues do not cover annual costs (point X) until at least three years, and losses in the early years are not recovered (point Y) until at least six years into a scheme's life.<sup>70</sup>

---

<sup>69</sup> Providers incur costs when they have to set up the scheme, add all the new members' details and payroll information, and transfer any pre-existing assets. Once a scheme is set up, the ongoing costs of administering the scheme are relatively low and are determined by the overall number of members, as well as the number of new joiners and leavers, rather than by the total amount of AUM. For example, providers incur the costs of member communications (such as annual statements), dealing with queries and updating details.

<sup>70</sup> Therefore, for schemes that only levy an AMC, it can take some time for a provider to recover costs, especially for new schemes or schemes with low existing assets. By contrast, winning an established scheme with higher existing AUM from rival providers can be more attractive, since such schemes will generate more revenue and winning providers would be likely to recover its set-up costs more quickly, for a given level of AMC. Conversely, providers may suffer losses on a scheme if it moves to another provider in the first few years, before the provider can break even and recover the initial costs of setting up the scheme.

Figure 4.3: OFT representation of annual revenue and cost profile of a typical scheme<sup>71</sup>



Source: OFT

4.20 Providers told us that achieving a return on capital is made more difficult due to the substantial investment in IT systems and

<sup>71</sup> This Figure shows the general shape of the annual revenue, annual cost, and overall profit/loss for a typical scheme that has a single AMC charge. It is a pictorial representation based on the evidence received from providers.

administration processes, which are required in order to operate as a pension provider.<sup>72</sup>

4.21 As a result providers therefore need to generate significant economies of scale so the revenue they generate from charges over the AUM meets their costs and provides a sufficient return on capital. This can create a barrier to entry as providers need to be confident that they will achieve sufficient scale in AUM to generate enough revenue from charges to cover their costs and make it profitable to enter the market. Scale in AUM is also important as providers' costs per scheme will decline if the pool of assets across which costs are spread increases.<sup>73</sup> A pension provider with greater AUM may also have more purchasing power with an investment manager, and may negotiate lower investment management charges.

4.22 These economies of scale may give rise to barriers to entry as they mean that established incumbent providers with greater scale will have a cost advantage over entrants until they also achieve scale.

#### Regulatory barriers

4.23 Insurance firms that provide contract based schemes and are registered with the FCA are subject to regulation on entry and on an ongoing basis. Contract based providers are required by the FCA to establish internal controls which mitigate significant operational, financial, regulatory and compliance risk. The FCA then monitors insurance firms through their supervisory processes and applies baseline monitoring activities including extensive analysis of a firm's financial returns.<sup>74</sup> Contract based providers are also subject to prudential capital requirements and will be monitored by the PRA or FCA to ensure the provider's financial safety and capital liquidity.

4.24 In contrast, whilst master trusts do have to submit scheme return data to TPR, they are not subject to the same level of prudential regulation as their contract based competitors. As a result of the differing

---

<sup>72</sup> Several providers submitted that fixed costs can be half or more than half of total costs.

<sup>73</sup> Costs do not vary with transaction or fund size. Processing a transaction of £1,000 costs the same as processing one of £100, but the revenue from the AMC is 10 times higher for the former.

<sup>74</sup> TPR (2013) Approach to work-based personal pensions, principles and features for good quality pension schemes. Available here: [www.thepensionsregulator.gov.uk/docs/principles-and-features-for-good-quality-pension-schemes.pdf](http://www.thepensionsregulator.gov.uk/docs/principles-and-features-for-good-quality-pension-schemes.pdf)

regulation between different types of scheme, several providers told us that it is easier to enter the market and compete as a master trust than as a contract based provider. This is consistent with the entry of several Master Trusts in recent years, but limited entry by contract based providers.<sup>75</sup> Nevertheless, most providers highlighted that regulatory requirements were a relatively small barrier to entry relative to financial barriers associated with economies of scale.

## Reputation

4.25 Some providers noted that it was important for them to establish themselves as 'credible' in the pensions market. This includes, for example, having a recognised brand name or a reputation for financial strength. This is largely to ensure that they receive backing from EBCs and IFAs, that until recently distributed over 77 per cent of schemes. Employers also highlighted the track record of a provider as being an important factor when they selected a scheme (see Chapter 5).

## Evidence of entry

4.26 While we have identified a number of potential barriers to entry, it appears that in practice there have been a significant number of new entrants to the work based pensions market – probably triggered by the new business that AE will create.

4.27 The vast majority of these new entrants have been master trusts. Entry has been concentrated over the previous two years. We identified more than 10 master trusts that have been initiated since September 2011 and there were 44 master trusts established in the UK in total in 2012.<sup>76</sup> Some insurance companies have also started to provide master trust schemes over the last two years. There has been little entry by new providers of contract schemes in recent years, with the exception of BlackRock. BlackRock entered the bundled DC workplace pension market in 1996, and recently started to offer contract based schemes.<sup>77</sup>

---

<sup>75</sup> See paragraph 4.27

<sup>76</sup> [www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

<sup>77</sup> [www.blackrock.com/institutions/en-gb/solutions/defined-contribution/full-services](http://www.blackrock.com/institutions/en-gb/solutions/defined-contribution/full-services)

4.28 The reason that the majority of new entrants into the market are master trusts appears to be because they have lower barriers to entry in this sector. Master trusts are subject to less regulation on entry and on an ongoing basis and this has the potential create a number of risks which are set out in further detail at Chapter 9. Further, some of these schemes are marketed as direct competitors to NEST, and can be accessed by employers without the requirement for an intermediary. These features are likely to appeal to AE entrants, and indicate that this market will experience future growth with the continued roll-out of AE.

## **Competition between providers**

4.29 There are two occasions when providers of pension services may compete:

- first, when the pension scheme is initially set up. There has been limited competition for new business in recent years, although this is set to change during the AE period, and
- second, if an employer or trustee decides to switch provider. To the extent that it takes place, switching has in recent years been the key source of competition, and following the completion of the AE process (once all employers have a pension scheme) it is likely to be again.

## **Value for money and the dimensions of competition**

4.30 In the OFT's view the following are key elements of a pension scheme that, when considered together, determine whether contributions are being saved into a scheme which offers value for money:

- The charges the scheme member has to pay – including charges paid for the administration of the scheme and for fund management services. Small differences in the level of scheme charges can make a significant difference to the value of a member's accumulated savings at retirement. For instance, a 0.5 per cent AMC over an employee's working life can reduce the overall value of a scheme member's retirement savings by around 11 per cent, whereas a one

per cent AMC can reduce retirement savings by around 21 per cent,<sup>78</sup> and

- The quality of the scheme, which includes:
  - the design and execution of the investment strategy
  - administration of the scheme and communication with the members, and
  - The governance of the scheme, which should involve assessments at regular intervals of how well the scheme is delivering on each of the key elements of value for money on an ongoing basis - including the level charges, investment strategy design and execution and scheme administration. This ensures that a scheme remains value for money into the future.

4.31 Overall it appears that supply side competition is focused on the two factors that employers appear to prioritise when choosing a scheme, the headline charge that the scheme member pays and administrative ease and compliance with AE requirements. There is however limited evidence of strong competition on scheme quality.

4.32 Both pensions providers and employers have told the OFT that the level of charges on a scheme is one of the most important factors to employers when they select a scheme. It appears that, in many cases, a competitive AMC is a minimum requirement for providers to be shortlisted by employers and their advisers. If the AMC is too high, then other indicators of a scheme's quality may not be taken into consideration. Providers suggested that the headline price is a critical factor in driving competition because it is observable and relatively easy to compare between different providers in the market. Evidence on competition on charges is discussed in more detail in Chapter 6.

---

<sup>78</sup> AMC is levied as a percentage of scheme members' accumulated savings every year. These figures assume a starting salary of £26,500 at age 25, and a 40 year investment period until retirement at age 65, annual growth in real earnings of two per cent, combined employee and employer contribution rates of 8.90 per cent, active contributions throughout the investment period, and real investment returns of five per cent. The impact of a 0.50 per cent Annual Management Charge reduces accumulated savings from £440,134.75 to £390,201.78 (11.3 per cent). The impact of a 1.00 per cent Annual Management Charge reduces accumulated savings from £440,134.75 to £346,670.16 (21.2 per cent).

- 4.33 Providers that had experience in competing for AE business have told us that administrative support through the process of automatically enrolling employees was another critical factor in winning new business. Employers want providers' administration to integrate with their payroll systems and for providers' systems to help employers identify employees that are eligible for AE and administer their contributions. The ease of administration appears to be a particularly important factor amongst providers that are preparing to compete for SME provision.
- 4.34 There is less evidence of competition on indicators of scheme quality - which is a key element of value for money. Some providers told us that they competed on member communications, the range of funds and investment options. However, employers have not indicated that quality factors feature strongly in their decision making processes. Further, one provider suggested that because the most common funds tend to be available across all key providers, the choice of funds is generally not a differentiating factor. Another suggested that a default investment solution that is appropriate for employees is only important when the provider is competing for 'paternalistic' rather than just cost-concerned employers. Evidence on competition over quality, including both investment management and administration is discussed in Chapter 7.

## Switching

- 4.35 Switching has until recently been the key dimension of competition and following the completion of the AE process it is likely to be again. However, the evidence that we have collected suggests that there is relatively low threat of switching and that switching is focused on larger schemes.
- 4.36 The OFT estimates that the average annual rate of switching all accumulated assets in schemes for the four calendar years from 2009 to 2012 was around 3.60 per cent of schemes and 6.69 per cent of assets<sup>79</sup> given that the percentage of assets that switched providers

---

<sup>79</sup> These rates are based on data submitted by providers, who jointly account for 78.0 per cent of schemes and 74.9 per cent of AUM in the whole OFT sample on 1 January 2013. The OFT estimates are obtained by dividing the number of schemes and assets these providers won by the total schemes and assets of these providers each year, and taking an average over the period 2010-2012.



between 2009-2012 is significantly higher than the percentage of schemes that switched, larger schemes with a greater level of AUM are more likely to switch provider.

4.37 In addition to collecting data on the frequency of switching, the OFT asked providers to submit the number of schemes that successfully re-negotiated an overall improvement in terms in the period from the 1st January 2012 to 31st December 2013 which, in turn, may have prevented the employer from moving to another provider. The proportion of re-negotiated schemes gives some indication of the competitive threat from employees threatening to switch providers. The data submitted from providers suggests that the average annual rate of employers' successfully negotiating improvements to overall terms (without switching the scheme) is around 0.40 per cent of schemes and 3.62 per cent of assets.<sup>80</sup> This suggests that in addition to being more likely to switch provider, larger schemes with more assets are also more likely to renegotiate terms with their current provider.

4.38 Low annual rates of switching and renegotiations can be compatible with good competition, if vendors respond to the threat of switching by keeping prices low and pre-empt the need for customers to switch or negotiate lower prices. The OFT considers this is unlikely to be the case in the DC workplace pensions market for two reasons:

- many providers set individual charges for each individual scheme, therefore switching and competitive pressure from a few engaged employers won't lead providers to lower charges for all other employers' schemes, and
- many employers and their employees are relatively inert and are unlikely to exercise competitive pressure on providers, as explained in Chapter 5.

4.39 The implication of the individual approach to pricing is that the threat of switching may not be fully effective in ensuring that competition drives low prices and improved quality across the market. In markets

---

<sup>80</sup> According to data submitted by providers, who jointly account for 48.8 per cent of schemes and 38.0 per cent of AUM in the whole OFT sample on 1 January 2013, the OFT estimates are obtained by dividing the number of successful schemes and assets by the total schemes and assets of these providers, and taking an average over the period.

where there is a single price for a product, providers may respond to the threat of switching by keeping prices low, pre-empting the need for customers to switch or negotiate lower prices. By contrast, in the workplace pensions market the decision to switch provider or negotiate terms only benefits scheme members whose employers are willing to switch.<sup>81</sup> Therefore, in order to secure better terms for their employees, employers need to switch or threaten to switch pension provider periodically.

4.40 Switching and the threat of switching may be constrained by a number of barriers. Probably the most significant barrier to switching across the market is likely to arise from employer inertia and incentive issues, as discussed in Chapter 5. However, in addition to this, there are a number of other switching barriers that apply on the contract based side of the market:

- As identified at Chapter 6 some 'legacy' contract based schemes sold prior to April 2001 have exit charges – these charges involve a one-off penalty being levied on members if they either stop regular contributions or prematurely withdraw funds.
- In addition, an employer is not able to switch contract based scheme assets without consent of the members to be transferred to a new provider. It is therefore for employers to persuade individual employees of why a switch is in their interests, which is likely to be time consuming and costly, particularly if an adviser is hired to explain the benefits of switching to members.
- The RDR may lead to a decline in switching of contract based schemes for two reasons:
  - first, advisers may have a reduced incentive to encourage switching. Providers told us that the RDR changes mean that employers are less likely to be encouraged by advisers (who historically were promoting switching in order to generate better commissions from providers) to switch pension provider once a scheme has been established. Faced with the costs associated with selecting and managing the transition to a new provider, including the potentially significant costs for implementing the

---

<sup>81</sup> With the exception of NOW, NEST and B&CE which have a single price for all schemes

systems required by the new scheme administrators,<sup>82</sup> and no advisers promoting switching, there may be fewer prompts for employers to switch pension schemes in the future, and

- second, because many contract based schemes have already been set up with in-built adviser commissions. Now that the RDR has banned this method of adviser remuneration (since January 2013), advisers are unlikely to recommend switching away from schemes that have these commissions built-in because this could lead to the loss of this revenue stream.

4.41 As discussed further at Chapter 8, many industry participants, including providers, have highlighted that the role that advisers have played in triggering switching on the contract based side of the market is likely to change. Advisers traditionally played a key role in encouraging schemes to switch. This is strongly supported by the fact that switching rates for commission-based schemes in the run-up to RDR were significantly higher than for non-commission schemes. Between 1 January 2009 and 2012, switching rates on non-commission schemes were 0.74 per cent of schemes or 5.28 per cent of assets compared to 5.33 per cent of schemes or 8.04 per cent of assets for commission schemes.

4.42 On the trust based side of the sector, there is greater potential for switching to work well. By putting in place competent, engaged trustees, employers can overcome the impact of their own potential lack of understanding and inertia. Further, trustees can switch assets without needing the consent of individual members.

4.43 Nevertheless there are still a number of barriers to switching in the trust based side of the market. One provider suggested that trustees can be 'locked in' to administration services in unbundled trust based schemes by advisers that have in-house administration teams. Our view is that these advisers are unlikely to recommend that employers transfer their unbundled administration services or switch to a bundled arrangement because it would result in a reduction of income for their administration services (and trustees might not approve the switch if it results in members paying a greater proportion of administration fees).

---

<sup>82</sup> Such as developing new data formats and IT processes or making existing data records fit for purpose

We have also been told by pension providers that bundled pension providers are unlikely to attempt to challenge this position by approaching employers directly if they have a relationship with the consultancies also providing the administration.

## Conclusion

4.44 Overall, we have concluded that the competition cannot be relied upon to ensure value for money for savers in the DC workplace pensions market.

4.45 However, our analysis has identified limited evidence that these are supply side factors that are limiting competition. The market is reasonably concentrated, market shares appear to have been relatively static over time and we have identified a number of potential barriers to entry. However, we have identified a significant number of new entrants to the market, particularly by master trusts where barriers to entry are lower, in response to AE. In fact, we are concerned that the lack of regulatory barriers to setting up a master trusts may have the potential to create detriment for consumers, as discussed in Chapter 8.

4.46 Our findings suggest that supply side competition has responded to demand side pressure on the headline scheme AMC and for schemes that offer administrative ease. There is limited evidence of strong competition on scheme quality - but this is likely to be the result of a lack of demand side pressure on these factors.

4.47 The key factors that are contributing to our concerns about competition failing to ensure value for money outcomes for savers are:

- the complexity of products and the difficulty involved in making judgements on both the cost and the quality of the product (see Chapter 6 and 7 respectively), and
- alongside this employers, who make the key decisions about pensions on behalf of their scheme members, may often lack the capability and/or the incentive to assess value for money on an ongoing basis (see Chapter 5).

4.48 Switching has until recently been the key dimension of competition and following the completion of the AE process it is likely to be again. There are, however, a number of barriers to switching arising from the inertia of the demand side of the market. The OFT is concerned that the relatively low threat of switching is not currently sufficient to deliver value for money across the market. This is because many pension providers set bespoke charges for each individual scheme, which means that switching and competitive pressure from a few engaged employers is unlikely to lead providers to also lower charges for all other employers' schemes. Scheme members are therefore unlikely to benefit from declining AMCs on newer schemes unless their employer opts to switch provider or to use the threat of switching to re-negotiate terms. The threat of switching may also fall further as the RDR reduces advisers' incentives to trigger switching (see Chapter 8).

## **5 ABILITY OF EMPLOYEES AND EMPLOYERS TO DRIVE COMPETITION**

- 5.1 Markets work well when consumers - in this case employers and employees - are incentivised to make well informed choices which reward those firms that best satisfy their needs. Active consumers with the ability to make informed choices provide firms with incentives to deliver what consumers want as efficiently and innovatively as possible.
- 5.2 This chapter explores the buyer side of the DC work based pensions market and looks at whether there is sufficient pressure from employees and their employers to drive competition in the market and in particular the knowledge, information, incentives and mechanisms available to them to do so.

### **The structure of decision making over DC work based pensions**

- 5.3 The buyer side of the DC work based pension market is split between decision makers - employers, and in some cases trustees and advisers – and employees who have limited influence over pension decisions, but receive the pension in retirement. There is no single decision maker with ultimate responsibility for member outcomes, which creates scope for misaligned incentives on the demand side of the market.
- 5.4 Even though employees are the recipients of defined contribution pension products, carry the investment risks, and suffer the consequences if the charges are high or investment decisions and administration are poor, they do not have responsibility for many of the key decisions that will affect the value for money of their pension.<sup>83</sup> Employees can choose to increase their personal contributions beyond the statutory minimum, which will have an impact on the value of their pension pot. However, most employees do not have access to ‘mechanisms’ within their work place, such as representation in pension governance committees, to directly put

---

<sup>83</sup> Although when an employee leaves employment, contract based schemes become personal pensions over which individuals have sole responsibility.

pressure on employers and, in turn, providers to act in their best interests. This has a bearing on the extent to which employees can drive competition in the DC work based pension market.

- 5.5 Employers, or where in place trustees, make most of the key decisions about their employees' pension arrangements. Often helped by an adviser, the employer takes responsibility for setting up the scheme, making contributions, and ensuring a default investment strategy is available to employees. However, as illustrated in Table 5.1, once the scheme is set up, decision making responsibilities differ depending on whether the employer chooses a trust or contract based scheme. In a trust scheme, trustees have an ongoing fiduciary duty to act in the members' best interest, and we look at the extent to which trustees are effectively exercising this duty in Chapter 7. In contract schemes, it falls to the employer to review the value for money of the scheme on an ongoing basis, although they have no legal requirement to do so.

Table 5.1: Employer and trustee responsibilities in trust and contract schemes

	Trust Schemes <sup>84</sup>	Contract Schemes <sup>85</sup>
<b>Set up</b>	Appointed trustees decide on the key elements: <ul style="list-style-type: none"> <li>• the default investment strategy</li> <li>• who will provide fund management services</li> <li>• who will provide administrative services</li> </ul>	Employer decides on who will provide administrative services and fund management for the scheme and ensures there is a default investment option.
	Trustees have a fiduciary duty to act in members' best interests.	Where employers consider whether the scheme meets member interests (such as

<sup>84</sup> The Pensions Regulator's guidance to trustees is available here:

[www.thepensionsregulator.gov.uk/guidance/guidance-for-trustees.aspx](http://www.thepensionsregulator.gov.uk/guidance/guidance-for-trustees.aspx)

<sup>85</sup> The Pensions Regulator's guidance to employers who set up contract based schemes is available here:

[www.thepensionsregulator.gov.uk/docs/employer-management-committees.pdf](http://www.thepensionsregulator.gov.uk/docs/employer-management-committees.pdf)

		actively designing the default fund), they are doing this by way of best practice and not because of any legal requirement to do so.
	Under AE, employers make contributions to employees' pension scheme.	Under AE, employers make contributions to employees' pension scheme.
<b>Ongoing</b>	Appointed trustees have an ongoing fiduciary duty to consider whether the scheme is performing in members' best interests.	No legal obligation on employers to consider whether the scheme is performing in members' interest on an ongoing basis. When a master trust is used, the trustee is often a corporate trustee chosen by the provider.

Source: OFT

## Employees' ability to drive competition

5.6 This section considers how the structure of decision making in the DC work based pension market and the nature of pension saving affects the ability of employees to drive competition. It considers:

- Employee understanding and levels of engagement.
- The mechanisms available to employees to influence decision making.

## Employee understanding and levels of engagement

5.7 Given the complexity of the pensions sector and the long-term commitment required to properly monitor the value of savings, most employees are not sufficiently knowledgeable or engaged in their work based pension to achieve good outcomes.



5.8 Most members of the public appear to find pensions complicated and lack a detailed understanding of the factors that will affect their income in retirement. For example, in 2011 the DWP study found that 63 per cent of people surveyed agreed that 'sometimes (state and private) pensions seem so complicated that I cannot really understand the best thing to do'.<sup>86</sup> When it comes to knowledge of DC work based pensions, most employees appear to have limited understanding of the importance of contribution levels, charges and the design and execution of the investment strategy. For example, 32 per cent of the active DC members surveyed by TPR in 2012 did not know any charges were levied against their pots, 38 per cent knew there were some charges but did not know how much they were and only 12 per cent thought they knew precisely what charges were taken from their pots.<sup>87</sup>

5.9 In addition to lacking knowledge about pensions, most members appear not to be actively engaged in assessing the value for money of their DC work based pension. Most members do not regularly check the performance of their funds, or the levels of charges being taken from their pots. For example, in 2012 TPR found that just under half (45 per cent) of active DC members have looked at their fund value in the last 12 months. Fewer still had looked at the growth of their fund over the last year (33 per cent) and only 21 per cent had looked at the charges associated with their scheme.<sup>88</sup> The employers we spoke to who had already automatically enrolled their employees confirmed that they had struggled to get their employees interested in workplace savings, suggesting that low levels of engagement in work based pensions is common across different sizes of employer.

5.10 Insights from behavioural economics can help explain low levels of employee understanding and engagement with their workplace pension. The FCA has looked at how consumers act in complex financial markets like the pensions market.<sup>89</sup> They found that most

---

<sup>86</sup> 63 per cent of those surveyed agreed, 16 per cent neither agreed nor disagreed and 20 per cent disagreed with the statement 'sometimes pensions seem so complicated that I cannot really understand the best thing to do'. Base: All respondents who are not retired (n = 1,329). Attitudes to Pensions: The 2012 Survey. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193372/rrep813.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193372/rrep813.pdf)

<sup>87</sup> TPR, Survey of DC Pension Scheme Members, 2012, p.12. Available here: [www.thepensionsregulator.gov.uk/docs/survey-of-dc-pension-scheme-members.pdf](http://www.thepensionsregulator.gov.uk/docs/survey-of-dc-pension-scheme-members.pdf)

<sup>88</sup> TPR, Survey of DC Pension Scheme Members, 2012, p.12. Available here: [www.thepensionsregulator.gov.uk/docs/survey-of-dc-pension-scheme-members.pdf](http://www.thepensionsregulator.gov.uk/docs/survey-of-dc-pension-scheme-members.pdf)

<sup>89</sup> FCA, Applying behavioural economics at the Financial Conduct Authority, 2013. Available here: [www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-1](http://www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-1)

consumers are likely to find making decisions related to financial products, such as DC pensions, complex, hard, unpleasant and time-consuming, and are likely to lack motivation to invest time and effort in these decisions. This is because the benefits of saving products such as pensions accrue in the future, with consequences of bad decisions revealed only after a long delay. Furthermore, decision making is difficult as performance is inherently uncertain and it is hard to judge the quality of investments over and above the performance of financial markets. In the DC work based pensions market, employees may also believe that the employer or trustee has made a good decision on their behalf and so do not scrutinise or question their decisions.

5.11 Many of the industry experts we spoke to emphasised that providers are taking these insights from behavioural economics into account and are developing new ways of helping employees make informed decisions about their retirement savings.<sup>90</sup> For example, Standard Life offers a 'member portal' as part of its standard product offering which allows employees to track performance of their investments online<sup>91</sup>. Aviva has also developed a 'Time to Act' application which allows members to see how much their pension fund might grow and the potential value of their income when they retire.<sup>92</sup> Such self-serve planning tools could help to engage employees in understanding how much they are saving and to make choices about their investment strategies.

5.12 The OFT recognises the importance of attempts to improve employees' understanding of the size of their pension pot and awareness of whether or not they are saving enough for retirement. However, most employees appear to persistently lack knowledge about their work based pension and, moreover, do not make many of the key decisions that will determine the value for money of their pension. The OFT therefore takes the view that investing in remedies to increase employee understanding of whether or not their pension is

---

<sup>90</sup> TPR argue that scheme providers should regularly send good quality communications to scheme members which clearly explain how much money they have saved, how their investments are being invested and how they have performed, what their projected savings will be at retirement, how much of their contributions will be taken in charges, and whether the desired retirement income can be achieved at the current rate of contribution. TPR (2013): A quick guide to selecting a good quality pension scheme for automatic enrolment, page 7.

<sup>91</sup> [www.standardlife.co.uk/1/site/uk/login](http://www.standardlife.co.uk/1/site/uk/login)

<sup>92</sup> [www.aviva.co.uk/media-centr/story/8160/aviva-launches-pension-iphone-app/](http://www.aviva.co.uk/media-centr/story/8160/aviva-launches-pension-iphone-app/)

providing value for money would not significantly strengthen the demand side of the DC work based pensions market. The remedies that we have developed therefore focus on improving employer decision making and increasing standards on the supply side of the market.

## **The mechanisms available to influence decision making**

5.13 The extent to which employers invest in governance structures which place employee considerations at the forefront of decisions about DC work based pensions appears to vary. The OFT is aware of some larger employers that have developed internal governance committees through which employees' priorities and investment preferences are taken into account and complaints can be heard. TPR's 2008 survey of the occupational DC landscape found that around half of the surveyed contract schemes had some form of governance arrangement in place to oversee the work based pension, although in some cases they were informal arrangements and may not have any written terms of reference.<sup>93</sup> Further, as small and medium (SME) sized employers may not have the resources to put well functioning committees in place, the use of governance structures within the work place is therefore unlikely to be a key feature of the DC pensions market once SMEs start to automatically enrol their employees.<sup>94</sup>

5.14 There are also few external mechanisms available to employees to influence employer choices or to ensure an employee is compensated for a poor choice made by their employer. Employees can complain directly to providers about the way their scheme is being run, they can request guidance from the Pensions Advisory Service and, if necessary, they are able to take unresolved disputes to the Pensions Ombudsman.<sup>95</sup> However, if an employer has chosen a scheme which offers poor value for money or if the terms of the pension become less competitive over time there is little that an employee can do. Opting out of the pension scheme altogether and using another savings

---

<sup>93</sup> TPR, DC research data on the occupational DC landscape plus results of independent research, January 2008, p.32. Available here: [www.thepensionsregulator.gov.uk/docs/defined-contribution-update.pdf](http://www.thepensionsregulator.gov.uk/docs/defined-contribution-update.pdf)

<sup>94</sup> See for example, Confederation of British Industry submission to House of Commons Work and Pensions Select Committee Improving governance and practice in work based pensions Sixth Report of Session 2012-2013. Available here: [www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/768/768we08.htm](http://www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/768/768we08.htm)

<sup>95</sup> Members could raise a complaint with the Financial Ombudsman Service if pension products can be shown to be unsuitable as sold. In cases of provider failure, employees' savings may be protected by the Financial Services Compensation scheme (if the provider is registered by the FCA).

mechanism is unlikely to be financially advantageous to the employee, as they will lose the employer's contribution.

5.15 Whilst employees may not be able to influence their employers' choices and drive competition between pension providers, they – in theory – have some degree of choice between fund managers once a scheme has been selected. Employees are able to switch their investments into lower charging or higher performing funds as long as the funds are available through their scheme.<sup>96</sup> However, multiple research studies on behavioural economics have raised serious doubts about the ability of individuals to make strategic investment decisions and make informed choices between funds.<sup>97</sup> It seems unlikely therefore, that most employees have the ability to drive competition by selecting funds that suit their preferences. Moreover, given that the DWP has estimated that between 80 and 95 per cent of members are in the default fund (and have not therefore made any active fund choice), it appears unlikely that sufficient competitive pressure could come from employees actively switching between funds.<sup>98</sup>

5.16 Overall, it appears that employees do not have the mechanisms, the motivation, or the understanding to drive competition on the key elements of value for money. In the next section, we consider the extent to which employers can drive competition on behalf of employees.

## **Employers' ability to drive competition**

5.17 This section considers the extent to which employers have the ability to drive competition in the DC work based pensions market. Providers told us that, to a great extent, the charges that an employee pays are determined by the characteristics of the firm for which they work. Employers which oversee schemes with large AUM, and have highly paid employees who are likely to remain at the firm for long periods of time (and therefore are likely to save more and generate more revenue

---

<sup>96</sup> TPR, Making pension fund choices, 2008. Available here: [www.thepensionsregulator.gov.uk/docs/making-pension-fund-choices.pdf](http://www.thepensionsregulator.gov.uk/docs/making-pension-fund-choices.pdf)

<sup>97</sup> Tapia, W. and J. Yermo, Implications of Behavioural Economics for Mandatory Individual Account Pension Systems, 2007, OECD Working Papers on Insurance and Private Pensions, No. 11, OECD Publishing. Available here: [www.oecd.org/insurance/private-pensions/39368306.pdf](http://www.oecd.org/insurance/private-pensions/39368306.pdf)

<sup>98</sup> Andrew Wood, Dominika Wintersgill and Niall Baker, Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, 2012, p.63. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193451/rrep804.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf)

for providers), are likely to have bargaining power to negotiate good terms on behalf of their employees.<sup>99</sup> To some extent these factors mean that larger employers, by nature of the characteristics of the firm, are in a stronger position to get value for money for their employees.

5.18 However, there are other factors which employers more directly control which will determine the extent to which they can drive competition and get value for money for their employees. In particular, the extent to which:

- employers have the knowledge and resources to drive competition, and
- employers prioritise all of the elements of value for money when they select a scheme and whether they are ensuring ongoing scrutiny of schemes.

## **Knowledge and resources of employers**

5.19 Employers' knowledge of DC work based pensions can help them to choose a scheme that offers their employees value for money. However, knowledge of work based pensions amongst employers, in particular the impact charges can have on member pots, appears to vary. In 2012, the DWP conducted a survey of employers who run trust and contract schemes which found that only a minority of employers (28 per cent of trust and 33 per cent of contract schemes) believed that members themselves paid any charges at all. Significantly fewer of the employers overseeing smaller schemes reported any member charges (only 11 per cent of trust schemes with six to 11 members and 21 per cent of contract schemes in the same size category thought their members incurred any charges).<sup>100</sup> Similarly, the NAPF found that in focus groups with SME employers, whilst nearly all participants were aware of AMCs, their awareness and knowledge of all other charges was poor, particularly for AMDs and flat rate charges. Some participants assumed that the charges

---

<sup>99</sup> The characteristics of the firm that affect the prices offered by provider are looked at in more detail in Chapter 6

<sup>100</sup> DWP (Andrew Wood, Dominika Wintersgill and Niall Baker) ,Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, 2012, p.37. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193451/rrep804.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf)

being discussed would actually be applied to the employers as opposed to the pension scheme members.<sup>101</sup>

5.20 A lack of knowledge on the part of employers in itself may not be disadvantageous for employees if the employer takes steps to overcome their lack of understanding, by seeking the support of a skilled adviser and/or putting in place structures (such as a trustee board) that help them ensure the value for money of a pension scheme is scrutinised.

5.21 However, given that some employers may not have the resources to fund this type of support, it is important that pension providers make available simple, comparable information, which allows employers to be able to assess value for money.

5.22 The OFT has found that inconsistencies and gaps in the pre-sale information about pension schemes might make it difficult for employers, particularly if they do not use an adviser, to assess value for money in the work based pensions market. We assessed the pre-sale information that providers send to employers against the 10 questions TPR recommend employers should ask providers when assessing the value of a pension scheme.<sup>102</sup> TPR's 10 questions provide a useful framework to evaluate the extent to which there are gaps and inconsistencies in the information sent to employers in order for them to be able to assess value for money. In the examples examined we found that information is not always consistently provided on key aspects TPR considers important for assessing value for money such as:

---

<sup>101</sup> The NAPF has also looked at employer understanding of pension charges and finds similar results: NAPF, Telling employers about DC pension charges, 2012. Available here: [www.napf.co.uk/PolicyandResearch/DocumentLibrary/~ /media/Policy/Documents/0261-Telling-Employers-about-DC-Pension-Charges-Research-Conducted-by-IFF-for-NAPF-and-BandCE%20b.ashx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~ /media/Policy/Documents/0261-Telling-Employers-about-DC-Pension-Charges-Research-Conducted-by-IFF-for-NAPF-and-BandCE%20b.ashx)

<sup>102</sup> TPR, Selecting a good AE scheme, 2012. The 10 questions TPR recommend employers ask providers are: are you able to demonstrate how the costs and charges paid by members represent value for money? Who is responsible for different aspects of running the scheme? How do we know those running the scheme are capable of doing so (both now and over the long term)? How are member interests represented and protected? How is money invested and how are these assets protected - and what happens if anything goes wrong? How can we be sure that members understand the investment decisions on offer and what happens if they do not make a decision? What flexibility is there around contribution levels? Are you able to demonstrate the extent to which you comply with the Pensions Regulator's record keeping guidance? Who will be the designated point of contact for members? What arrangements will be in place to assist members at retirement? TPR has recently updated these questions – TPR, A quick guide to selecting a good quality pension scheme for AE, 2013. Available here: [www.thepensionsregulator.gov.uk/docs/employer-select-pension-automatic-enrolment.pdf](http://www.thepensionsregulator.gov.uk/docs/employer-select-pension-automatic-enrolment.pdf)

- how the scheme will be governed, who is responsible for governing the scheme (and how they are appointed)
- the performance of administration services against TPR's record keeping guidance, and
- what services are included in the AMCs and how the AMC compares to alternative providers.<sup>103</sup>

5.23 Gaps in pre-sales information may not have been a significant problem to date as advisers, with knowledge and expertise in assessing value for money, are in a strong position to ask providers further questions and clarify the suitability of the product. However, as the RDR ban on commission and the subsequent ban on consultancy charges<sup>104</sup> means employers will have to bear the cost of advice themselves, they may decide to 'go it alone' and choose a scheme without the help of advisers. The OFT is concerned that non-advised employers will find it difficult to assess value for money from the pre-sales information currently available. The OFT welcomes industry-led initiatives to standardise charges and provide a consistent template which should allow employers to quickly compare whether or not a pension provider includes certain services in the charges paid. However, it recommends that the DWP consider whether more could be done to make comparable information about the quality of pension schemes available to employers.<sup>105</sup>

## **Additional structures or resources employers can put in place**

5.24 There are a number of steps employers can take to ensure that their work based pension scheme is providing value for money. The three key options (all of which an employer could adopt) are:

- internal governance processes dedicated to pension oversight
- using advisers to help them identify appropriate schemes and negotiate a good deal, and

<sup>103</sup> The different definitions of AMC is explored further in Chapter 6

<sup>104</sup> Under the terms of RDR advisers helping employers to set up and administer contract based schemes could have agreed a consultancy charge with the employer, rather than being paid commission by the pension provider. The agreed consultancy charge could have been taken directly from the scheme if the employer was unable to unwilling to pay for it. The government has since published draft legislation banning consultancy charges AE schemes set up after 10 May 2013. The DWP anticipates that these draft regulations will be debated in Parliament in October and, subject to Parliamentary approval, come into force by November 2013.

<sup>105</sup> ABI and NAPF, Pension Charges Made Clear: Joint Industry Code of Conduct, 2012. Available here: [www.napf.co.uk/PolicyandResearch/~ /media/Policy/Documents/0273\\_Pensions\\_charges\\_made\\_clear\\_code\\_of\\_Conduct.ashx](http://www.napf.co.uk/PolicyandResearch/~ /media/Policy/Documents/0273_Pensions_charges_made_clear_code_of_Conduct.ashx)



- appointing trustees to oversee the pension on behalf of employees.

5.25 The OFT has identified a number of good governance practices that employers have put in place to provide ongoing scrutiny and member input into decision-making on contract schemes.<sup>106</sup> For example, Heineken has set up a Group Personal Pension (GPP) scheme with a governance committee which monitors both the provider and the performance of the investment options available to members, and maintains a Statement of Investment Principles (SIP). The SIP sets out the governance committee's investment objectives and beliefs, and how the investment options are designed and monitored.<sup>107</sup> Providers told us that these practices were new and tended to be limited to the larger employers with the resources to dedicate to developing these governance structures.

5.26 However, many employers, particularly smaller employers, are unlikely to have the resources to be able to put in place this type of internal governance. As part of its research, the OFT carried out four focus groups with SMEs to get a better understanding of the resources available to dedicate to pension oversight. The SMEs that took part did not have a pensions department, pensions committee, or even a human resources manager dedicated to assessing the products available in the market and negotiating a quality deal on behalf of their employees. One participant suggested that it would not be cost efficient to dedicate resources to pension oversight and that there was limited pressure from their workforce to prioritise pensions. In our view, it seems likely that smaller employers, with fewer resources or time to dedicate to pension oversight, are likely to be weaker buyers in the pensions market.

---

<sup>106</sup> TPR (2008) DC research Data on the occupational DC landscape plus results of independent research January 2008 [www.thepensionsregulator.gov.uk/docs/defined-contribution-research.pdf](http://www.thepensionsregulator.gov.uk/docs/defined-contribution-research.pdf)

<sup>107</sup> Heineken's committee structure includes a governance committee and a member nominated representative. In combination with regular updates to our council employees' priorities and preferences are taken in to account when selecting their provider and designing the DC fund structure and supporting material. See articles [www.pensionsweek.com/Investment/What-Heineken-s-SIP-tells-members-on-investments](http://www.pensionsweek.com/Investment/What-Heineken-s-SIP-tells-members-on-investments)

TPR (2008) DC research Data on the occupational DC landscape plus results of independent research January 2008 [www.thepensionsregulator.gov.uk/docs/defined-contribution-research.pdf](http://www.thepensionsregulator.gov.uk/docs/defined-contribution-research.pdf)  
[www.professionalpensions.com/professional-pensions/interview/2154640/dc-default-campaign-heineken-interview/page/2](http://www.professionalpensions.com/professional-pensions/interview/2154640/dc-default-campaign-heineken-interview/page/2)



## The use of an adviser

- 5.27 Many of the providers and advisers the OFT spoke to suggested that employers who use a good financial adviser can get a better deal for their employees. Several providers gave estimates of the typical reduction in AMC that advisers renegotiate on behalf of employers with schemes already set up. These range from 0.05 to 0.30 percentage points. Further, providers told us that, because good advisers can convince employees to switch scheme, the adviser can make the switch more attractive (financially) to the receiving provider and their involvement can result in terms which are better for members.
- 5.28 Whilst employers appear to show willingness to use advisers to help them make pension decisions, there appears to be reluctance amongst many employers to pay specific fees for AE advice. At least 50 per cent of the employers surveyed by TPR in 2013 suggested that they would be unwilling to pay additional fees (beyond any they may already pay) for assistance with AE.<sup>108</sup> This suggests that many employers, particularly smaller employers, may not pay for advisers to help them negotiate a good deal on behalf of employees.
- 5.29 When employers have used an adviser in the past, we heard concerns that advisers may, in some cases, have made decisions on the basis of maximising their own income streams. Providers and advisers told us that such activity mainly occurred before January 2013 when commission-based advisers were paid by providers for distributing their pension products and, as outlined in Chapter 4, for encouraging an employer to switch their pension scheme to an alternative provider.<sup>109</sup> Many industry respondents told us this meant, in practice, that advisers would recommend the provider which offered the best rates of commission. Providers who paid commission may have been competing on the basis of the proposition - including commission - that they offered to intermediaries, rather than exclusively on the merits of the products that they could offer employers and their employees.

---

<sup>108</sup> TPR, AE: commentary and analysis , 2013

<sup>109</sup> In January 2013 the RDR changes came into effect, banning commission-based advice.

5.30 The onset of RDR and the DWP's ban on consultancy charges should mitigate this conflict of interest and not result in any direct adviser costs paid by members.<sup>110</sup> However, as advice to employers about the choice of provider is not regulated by the FCA, the OFT has concerns about how advisers manage and disclose conflicts of interest when they offer services on which they also advise.<sup>111</sup> These concerns are further explored in Chapter 8.

## The use of trustees

5.31 An employer's lack of pension knowledge may not be a concern if the employer chooses to set up a trust based pension scheme which is overseen by well resourced, capable trustees. The Pensions Regulator estimates that there are currently 39,000 DC schemes with 600,000 active members that have trustees.<sup>112</sup> Trustees have a fiduciary duty to members of a scheme to make decisions in their interest, although the ability of trustees to get value for money for members will depend on their capability and the quality of the advice they receive.

5.32 Trustees of large trust schemes (with over 1000 members) appear to offer effective governance and a high level of trustee oversight.<sup>113</sup> The trustees, providers and fund managers the OFT interviewed suggested that large trust schemes are likely to have skilful people on their trustee boards. These people will have the knowledge, expertise, and advice to exert ongoing pressure on providers to ensure they provide quality administration and fund management services.

5.33 In contrast, trustees in small and medium trust schemes appear to provide poorer governance, although there are exceptions. A recent TPR review, for example, showed that 52 per cent of small schemes and 38 per cent of medium schemes had not reviewed their Statement

---

<sup>110</sup> The exception to this rule is where employers enrol their employees into a scheme where legacy trail commissions are still built into the scheme's AMC and employees therefore still bears the cost of commissions paid by providers to advisers. See

[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193451/rrep804.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf)

<sup>111</sup> Investment advice is regulated by the FCA.

<sup>112</sup> This compares with 1,800 DC –contract based schemes with 2.6 million active members that do not have trustees. See: [www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

<sup>113</sup> Scheme sizes are defined as follows: small schemes have 12-99 members, medium schemes have 100-999 members, large schemes have 1000 or more members. See also DWP, The use of vesting rules and default options in occupational pension schemes, 2011. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214500/rrep725.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214500/rrep725.pdf)

of Investor Principles in the last three years, even though it is a legal requirement. In comparison, 85 per cent of large schemes had done so.<sup>114</sup> These problems can arise when trustees in these smaller schemes have lower levels of skills and resources and when they do not have access to quality independent advice.

5.34 The evidence indicates that many employers do not have the knowledge or understanding to ensure they get value for money in the DC work based pensions market. Larger employers are able to overcome this by putting in place appropriate governance structures or by using advisers. However not all employers have the resources to do this - and we are likely to see the number of resource constrained employers grow during the AE period.

### **Employers' incentive to drive competition**

5.35 The OFT has considered whether employers, in practice, have the incentive to drive competition in the work based pensions market. We have considered whether employers have the incentive to:

- select a scheme that will provide scheme members with value for money, and
- ensure that there is ongoing scrutiny to ensure value for money in the long term.

### **Employers' priorities when choosing a pension scheme**

5.36 Employers' priorities when it comes to choosing a pension scheme on behalf of their employees can affect the type of scheme they choose and ultimately member outcomes. There may be some alignment between employers' and employees' priorities. For instance, employers may see a good pension scheme as a way to attract and retain employees. They may also be keen to select a scheme that is administratively well run to avoid any employee discontent or negative publicity arising from the pension service that they offer their employees.

---

<sup>114</sup> TPR, Occupational pension scheme governance: Accompanying Technical Report on the 13th (seventh) scheme governance survey, 2013.

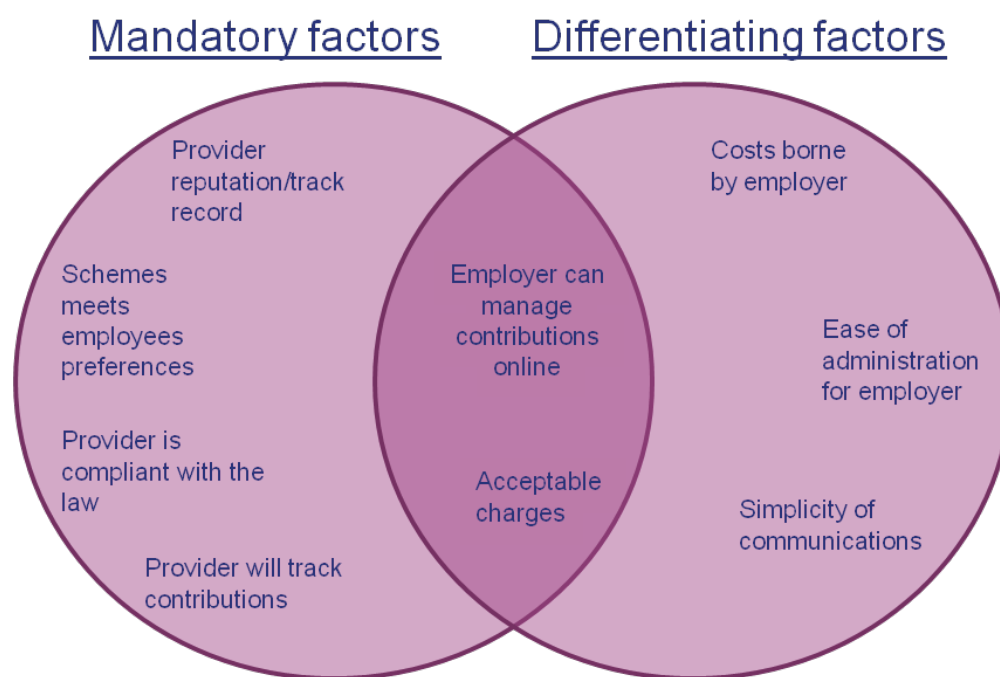
5.37 However, this general alignment does not necessarily mean that employers prioritise all the key elements of value for money when they choose a pension provider. As part of its research, the OFT conducted four focus groups with SMEs to get a better understanding of what smaller employers prioritise when they choose a pension scheme. As illustrated in Figure 5.2, based on our focus groups it appears that when SME employers want to set up a new scheme there are a set of 'mandatory' factors that all providers would need to demonstrate and a set of 'differentiating' factors which would set a provider apart from its competitors. These differentiating factors were the administrative help providers could offer employers in setting up the scheme, low upfront costs paid for by the employer, simplicity of communications (including online tools) and low charges paid by the member.<sup>115</sup> It was noticeable that the SMEs we spoke to did not appear to prioritise other factors that determine scheme quality such as the standard of investment strategy or scheme governance.

5.38 Based on the insights from our focus groups, it seems that the providers which compete on low costs borne by employers and provide simple administration and straightforward communications are likely to be favoured by SME employers, possibly at the expense of other factors that contribute to value for money. Whilst these insights are not necessarily representative of all employers in the DC work based pension market, the concern that employers, particularly smaller employers, will not prioritise all the factors that contribute to value for money when choosing a pension scheme was also raised by many providers.

---

<sup>115</sup> Although they were not aware of what specific charges would be paid for by the member or employer

**Figure 5.2: The factors small and medium sized employers prioritise when choosing a pension scheme**



Source: OFT focus groups

5.39 Evidence also indicates that when SMEs already have a pension scheme many will want to use their existing scheme for AE, regardless of whether it offers the best value for money currently available in the market.<sup>116</sup> In our focus groups, the SME employers that already had a pension scheme in place told us that when they have to enrol the rest of their employees they would speak to their current provider to see if their existing pension could be made to comply with AE. If their current scheme was AE compliant (or could be made to be compliant) then they would be unlikely to assess alternative options available on the market that could offer better value for their employees.<sup>117</sup>

5.40 We are particularly concerned that in some cases the existing schemes that employers propose to use have adviser commission built into the scheme's AMC. Where an employer has used a commission-based

<sup>116</sup> Employers' preference for using the incumbent scheme is supported by work by DWP and Aon Hewitt, John Forth, Lucy Stokes, Alice Fitzpatrick and Catherine Grant, Employers Pension Provision Survey 2011. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193460/rrep802.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193460/rrep802.pdf); Aon Hewitt Auto-enrolment Survey 2012, Available here: [www.aon.com/unitedkingdom/attachments/thought-leadership/auto\\_enrolment\\_survey\\_summary.pdf](http://www.aon.com/unitedkingdom/attachments/thought-leadership/auto_enrolment_survey_summary.pdf)

<sup>117</sup> To qualify as a scheme for AE schemes need to: facilitate the payment of contributions for the employer's payroll, offer a default investment fund and deliver a minimum accrual rate or minimum contribution .

adviser to set up a work based pension scheme before the RDR implementation date (January 2013), the adviser can continue to receive ongoing 'trail' commission in relation to his or her pre-RDR advice until the product matures or is terminated.<sup>118</sup> If new members are enrolled into a scheme with 'trail' commission built into the AMC then new members may pay these commissions.<sup>119</sup> There is therefore an incentive for advisers to recommend the employer to use the incumbent scheme (when better alternatives might be available), and employers may be reluctant to consider alternative schemes for AE as they would then have to bear the costs of advice associated with setting up a new scheme. Employees may therefore be enrolled into the existing scheme and pay commission (without necessarily benefiting from quality advice) even if more competitive alternatives are available.

- 5.41 As there are currently no 'quality' requirements to be a qualifying scheme for AE, the OFT is concerned that employers' preferences for using the incumbent provider for AE might result in existing schemes, possibly with uncompetitive features, becoming an employer's AE scheme for its entire workforce.

### **Ongoing scrutiny of value for money**

- 5.42 The ongoing scrutiny of a work based pension scheme is important to ensure that charges and investment strategies are kept up to date with the terms offered to new schemes. The OFT has found that many schemes set up before 2001 have not benefited from ongoing scrutiny and pressure to switch these schemes to providers offering more competitive terms (explored in Chapter 6). In the DC workplace pensions market this ongoing scrutiny can come from employers and, when in place, trustees. However, some employers appear to lack the incentive to revisit and reassess the quality of a pension scheme once it has been set up.

---

<sup>118</sup> FSA, Distribution of retail investments: delivering the RDR - feedback to CP09/18 and final rules, 2010. Available here: [www.fsa.gov.uk/pubs/policy/ps10\\_06.pdf](http://www.fsa.gov.uk/pubs/policy/ps10_06.pdf)

<sup>119</sup> FSA, Distribution of retail investments: RDR Adviser Charging – treatment of legacy assets, 2012. Available here: [www.fsa.gov.uk/static/pubs/policy/ps12-03.pdf](http://www.fsa.gov.uk/static/pubs/policy/ps12-03.pdf) However, providers may not be willing to pay commission to advisers for new members that are enrolled into existing schemes if, for example, the providers will not profit from the scheme being expanded to new members.

5.43 The SMEs that took part in our focus group had a limited appetite for periodically reviewing the performance of their work based pension provider and its default investment strategy. The selection of a pension provider was seen as a 'one off' decision by many employers that took part. Employers may not choose to invest in the ongoing scrutiny of their work based pension scheme because it may be costly to do so. Whilst this may be understandable, we are concerned that SME employers will not provide the scrutiny needed to ensure schemes continue to deliver value for money over the longer-term. We also note that employer-led oversight may be lower for deferred members and schemes that are closed to new members.<sup>120</sup>

5.44 The lack of appetite that some employers have displayed for ensuring periodic scrutiny over the value for money of their schemes is reflected in our findings on the frequency of switching and re-negotiation of terms. These findings are considered in Chapter 4.

5.45 Overall, it appears that some employers are willing to do more to ensure that their employees receive ongoing value for money than others. Some employers, if they have resources to dedicate to scrutinising the market and paying for advisers, may ensure that the key elements of value for money are prioritised when they set up a scheme and will ensure ongoing scrutiny of value for money through putting in place good governance. However, other employers, in particular smaller and medium sized employers, have made it clear to the OFT that they may prioritise minimising their own costs once the scheme has been set up, and do not in all cases envisage providing ongoing scrutiny.

## Conclusion

5.46 As set out in more detail in Chapters 6 and 7, the complexity of pension products makes decision making on value for money very difficult. For DC pension scheme members to obtain value for money the buyer side of the market needs to be knowledgeable, engaged and committed to ensuring ongoing monitoring.

---

<sup>120</sup> Deferred members are those that have stopped contributing to the pension scheme (the most common reason for becoming a deferred member is that the employee has moved jobs).

5.47 However, on the basis of our analysis, the buyer side of the work based DC pensions market appears to have a number of significant weaknesses:

- First, unlike most other well functioning markets, the ultimate beneficiary of the product, the scheme member, is not responsible for selecting or monitoring the value for money of the product. Instead, the procurement of the product is the responsibility of the employer.
- Second, DC pensions are very complex and benefits accrue in the distant future which means that beneficiaries are unable or lack incentive to engage actively and exert pressure on employers to act in their interests.
- Third, the evidence we have gathered suggests that while employers have the primary responsibility for taking the key decisions associated with a scheme, many do not have the ability or the incentive to drive competition on the key elements of value for money.

5.48 Much therefore depends on whether employers have the necessary resources to supplement their understanding and ensure that these decisions are taken well - by using advisers and embedding good governance.

5.49 However, the OFT focus group research suggests that many SME employers that are automatically enrolling employees into pensions for the first time are likely to prioritise finding administrative solutions to the task of automatically enrolling their employees. While some are also likely to prioritise ensuring that the charges their employees face are as low as they can be, there is little evidence that employers have the capability and resources to recognise the importance of prioritising the other key elements of value for money such as investment design and performance or scheme governance. Beneficiaries of the pension scheme (employees) are also not in a good position to ensure that their employer is acting in their best interest. This creates a number of risks including:



- employers may use their existing pension scheme for AE without considering whether it is the most competitive option for their employees
- employers may choose providers that promise to solve their administration problems and minimise the employer's upfront costs without considering other aspects of value for money
- employers may not provide for any sort of ongoing scrutiny of value for money - meaning that employees could become stuck in schemes with obsolete investment strategies or charges that no longer reflect the market rate.

5.50 The OFT welcomes measures taken to address the problems identified on the buyer side, such as providers developing ways of encouraging member engagement, and the industry-led initiative to make the services offered by providers more comparable. However, given the weakness of the buyer side of the market created by the fragmentation of decision making responsibilities, the split between decisions makers and the ultimate beneficiaries of the workplace pension with limited understanding and engagement amongst consumers, the OFT considers that such measures as these are unlikely, on their own, to lead to satisfactory outcomes. Therefore, the OFT has focused on improving scheme governance because this can act as a substitute for the buyer side weakness and mitigate some of the risks of unadvised employers moving into the DC pensions market.

## 6 CHARGES AND COSTS OF INVESTING

### Introduction

6.1 The charges that a pension scheme member pays are a key element of value for money of their scheme. Small differences in the level of scheme charges can make a significant difference to the value of a member's accumulated savings at retirement. For instance, a 0.5 per cent Annual Management Charge (AMC) over an employee's working life can reduce the overall value of a scheme member's retirement savings by around 11 per cent, whereas a one per cent AMC can reduce retirement savings by around 21 per cent.<sup>121</sup>

6.2 This chapter sets out:

- how charges are levied on pension schemes
- recent trends in the level of charges
- the way that competition on charges is working and the factors that might inhibit competition on charges, and
- the impact that some of the potential barriers to competition on charges may be having.

### How charges are levied on pension schemes

6.3 There are a wide range of costs and charges that are paid by a pension scheme member. In order to understand the level and trends in these charges we have gathered data on them from providers of contract-based and bundled trust-based schemes. We have also reviewed research that DWP has carried out on charging levels in the market to supplement our understanding, particularly on the unbundled trust side of the market where less data on charges is available.

---

<sup>121</sup> An Annual Management Charge (AMC) is levied as a percentage of scheme members' accumulated savings every year. These figures assume a starting salary of £26,500 at age 25, and throughout a 40-year investment period until retirement at age 65, annual growth in real earnings of two per cent, combined employee and employer contribution rates of 8.90 per cent, active contributions throughout the investment period, and real investment returns of five per cent. The impact of a 0.50 per cent Annual Management Charge reduces accumulated savings from £440,134.75 to £390,201.78 (11.3 per cent). The impact of a 1.00 per cent Annual Management Charge reduces accumulated savings from £440,134.75 to £346,670.16 (21.2 per cent).

- 6.4 The evidence that we have gathered suggests that, prior to the introduction of stakeholder pensions in 2001, scheme members paid many different charges, including AMCs levied on the accumulated assets, fixed monthly fees and initial charges levied as a percentage of members' contributions. During our evidence gathering, providers have told us about four broad categories of charge being levied on pre-2001 schemes – our analysis of the additional charges on 'legacy' schemes is set out in more detail at paragraphs 6.42 to 6.51 below.
- 6.5 When stakeholder pensions were introduced in April 2001, the pensions industry moved towards levying a single charge, known as an AMC, although this did not preclude other charges being levied as well. The AMC is levied as a percentage of the scheme member's accumulated funds. However, even for schemes set up after 2001, the AMC is not calculated in a consistent way across the industry. For example, providers do not always include all investment management service charges, expenses, and transaction costs. We have set out further details about some of these additional charges that may not always be included within the AMC in our analysis of the comparability of charges (paragraphs 6.19 to 6.33).
- 6.6 To the extent that competition on charges takes place in the pensions market, it tends to focus on the level of the visible AMC. Both providers and employers ranked the AMC as one of the key factors of competition.<sup>122</sup> In many cases, a competitive AMC is a minimum requirement for providers to be shortlisted by employers and their advisers. The next section sets out our analysis of the AMC being paid by pension scheme members.

## **Analysis of AMC**

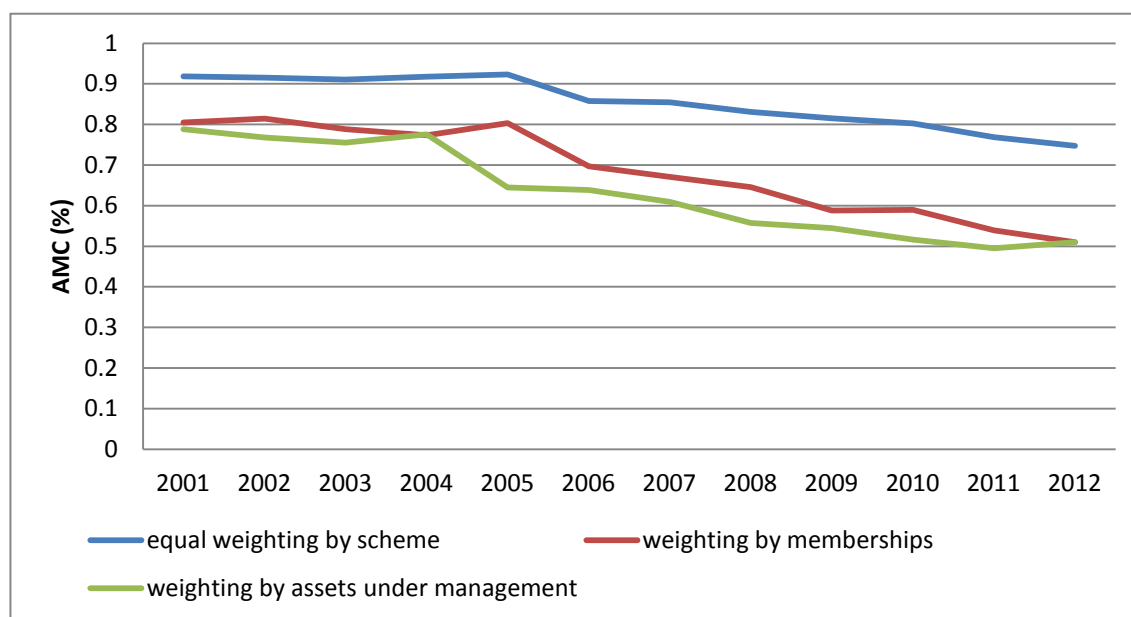
- 6.7 According to data from pension providers, AMCs are lower on contract and bundled-trust based pension schemes that have been set up more recently. The average AMC for schemes set up each year for contract based schemes and bundled trust based schemes has fallen from 0.79

---

<sup>122</sup> Other prominent factors are: service quality, efficiency, and reliability; member engagement and communications; range of funds and investment options; ease of implementation for employers, providing technological or online functions that help employers to meet their AE obligations. These are discussed in Chapter 5 and Chapter 7.

per cent in 2001 to 0.51 per cent in 2012 (see Figure 6.1).<sup>123</sup> This finding is consistent with the views of most industry participants, who have told us that AMC's have been falling in recent years.<sup>124</sup>

**Figure 6.1: Average AMC on schemes set up by contract-based and bundled trust-based pension providers in each year**



Source: OFT, based on data submitted by providers

<sup>123</sup> The exact level of the average AMC observed may not fully account for differences in how providers calculate or define their AMC. (More information on these differences can be found in paragraphs 6.19 to 6.33 below.) However, providers confirmed that they have not changed the way in which they calculated or defined AMC over the period from 2001 to 2012, so the OFT is reasonably confident that there has been a decline in the average AMC.

<sup>124</sup> The DWP has also carried out two surveys on pensions charges, in 2009 and 2011. As part of their survey, the DWP contacted an effective sample of around 4,200 employers in 2009 and 976 employers in 2011 with trust based and contract based schemes and asked about the level of charges. The sample of trust-based schemes included both bundled and unbundled schemes and, for the survey in 2011, the DWP confirmed with the OFT that there was not a significant difference in the level of charges between bundled and unbundled trust-based schemes.

The DWP found that the average AMC for trust-based schemes was 0.71 per cent and for contract-based schemes was 0.95 per cent in 2011. These figures are not directly comparable with the OFT's average charge, as the DWP reported a simple average AMC across schemes, whereas the OFT is reporting what is effectively a weighted average AMC across scheme assets. The OFT figures therefore place a higher weight on the AMC of schemes with more assets under management.

In terms of understanding trends in AMC over time, it is difficult to make use of the DWP's work as there have only been two surveys thus far, and because the DWP altered the methodology between 2009 and 2011, which means the reported averages in 2009 and 2011 are not directly comparable.

DWP, Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, 2012. Available here:

[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193451/rrep804.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf)

DWP, Charging levels and structures in money-purchase pension schemes:

Report of a quantitative survey, 2010. Available here:

<http://webarchive.nationalarchives.gov.uk/20130314010347/http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep630.pdf>

Notes: This figure shows the AMC at 1 January 2013 for schemes that were set up in each calendar year.

It is based on information submitted by five providers that account for 55 per cent of schemes, 46 per cent of memberships, and 54 per cent of the OFT sample.<sup>125</sup>

2. Providers reported various averages across their schemes' AMCs, and the OFT calculated a simple average across the providers' reported averages. Therefore, the figures should be interpreted with caution, as the reported average under-weights the AMC of providers with larger market shares and over-weights the AMC of providers with smaller market shares, relative to the true average AMC in the market.

3. The blue line is based on the simple average AMC across providers' schemes. The red line is based on the membership-weighted average AMC, which gives more weight to the AMC of schemes with more memberships.

4. The green line is based on the asset-weighted average AMC, which gives more weight to the AMC of schemes with more assets under management.

5. The exact level of the average AMC observed may not fully account for differences in how providers calculate or define their AMC. Providers' reported AMC includes funded initial commission and fund-based commission to advisers. Providers have not changed the way in which they calculated or defined AMC over 2001 to 2012, so year-on-year comparisons are valid.

## 6.8 There are a range of factors that may have contributed to this fall in average AMC on schemes set up more recently:

- Assets under management in DC workplace schemes are growing over time. The higher the level of assets under management, the higher the revenue from any given level of the AMC. For schemes with large assets, providers can lower the percentage AMC charged and still generate enough revenue to cover costs over time.<sup>126</sup>

Providers have told us that the majority of schemes set up in the years leading up to 2012 were schemes that already had assets under management that had switched from other providers. Some employers appear to have used this increased bargaining power of having more assets under management to negotiate lower charges.

- Some providers have told us that they have improved their back office systems, thereby reducing their costs.
- Government intervention in the market appears to have led to lower 'benchmarks' for charges. In 2001, the introduction of stakeholder pensions with a one per cent AMC cap created a new competitive benchmark for other workplace pension schemes.<sup>127</sup> Some providers

---

<sup>125</sup> As discussed in Chapter 4, it is difficult to gather consistent information on overall market size of the DC workplace pensions market. The OFT sample does not cover the full market, as some market players did not submit their data to us, but the OFT sample is likely to be the most comprehensive available estimate for contract based and bundled trust based schemes.

<sup>126</sup> A related fact, that schemes with higher assets under management tend to have lower AMCs, is also illustrated in Figure 6.1, as the average AMC which gives more weight to schemes with more assets, which is the green line, is below the simple average, which is the blue line.

<sup>127</sup> The Stakeholder Pensions Schemes (Amendment) Regulations 2005 increased the stakeholder pension charge cap. For new members from 6 April 2005, the charge cap was 1.5 per cent per annum, reducing to one per cent

have told us that they re-priced and re-structured schemes so that they had a single AMC charge below one per cent. More recently, NEST was created in July 2010<sup>128</sup> as part of the government's recent pension reforms. NEST has an equivalent AMC of around 0.5 per cent, which may have put downward pressure on AMC levels on schemes set up more recently.<sup>129</sup>

- During the past decade, some providers moved away from setting up schemes with in-built adviser commissions. In schemes with in-built commissions, part of the AMC paid by the scheme member went to the adviser for distributing their products. The decision by some providers to stop offering these schemes in advance of the RDR (which prevents this method of adviser remuneration from January 2013) may therefore have contributed to lower AMCs for schemes set up in recent years.
- It has also been suggested that the poorer performance of funds since the credit crisis may have led to a greater focus on scheme charges relative to performance.

## Distribution of AMC

6.9 Although those setting up new schemes may have been able to obtain lower AMCs, there is still a wide variation in the level of AMCs being paid by members of contract and bundled trust based schemes. Figure 6.2 suggests that the lowest AMC being paid is 0.05 per cent and the highest, 2.30 per cent.

6.10 Figure 6.3 indicates that the majority of scheme members' assets are being charged at an AMC of less than one per cent, with only three per cent of assets under management in contract or bundled-trust based schemes with an AMC of above one per cent. Figure 6.3 also shows that there is a high proportion of assets with an AMC just below one per cent – 24 per cent of assets have an AMC of between

---

after 10 years of continuous membership in the scheme. The charge cap was increased to enable providers to market stakeholder pensions more proactively to lower and moderate earners and hence to encourage more people to save for retirement.

<sup>128</sup> NEST, NEST website article, The story so far – a timeline of pensions reform and NEST. Available here: [www.nestpensions.org.uk/schemeweb/NestWeb/public/whatIsNEST/contents/our-story.html](http://www.nestpensions.org.uk/schemeweb/NestWeb/public/whatIsNEST/contents/our-story.html)

<sup>129</sup> On the equivalent AMC charge of 0.5 per cent for NEST, see [www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/briefing-note-low-charges,PDF.pdf](http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/briefing-note-low-charges,PDF.pdf)

0.9 and one per cent. This is consistent with what pension providers told us about their responses to the introduction of stakeholder pensions in 2001, with new business being written and some schemes being re-priced at or below a one per cent AMC in response to this competitive benchmark.

6.11 Nevertheless, in absolute terms, there remains a significant number of pension scheme members that are paying an AMC of above one per cent. Approximately 186,000 pension pots with £2.65 billion assets are in schemes with an AMC above one per cent.<sup>130</sup> A number of providers indicated to us that an AMC of above one per cent is higher than an individual may expect to pay if they bought a personal pension product and is therefore arguably difficult to justify.

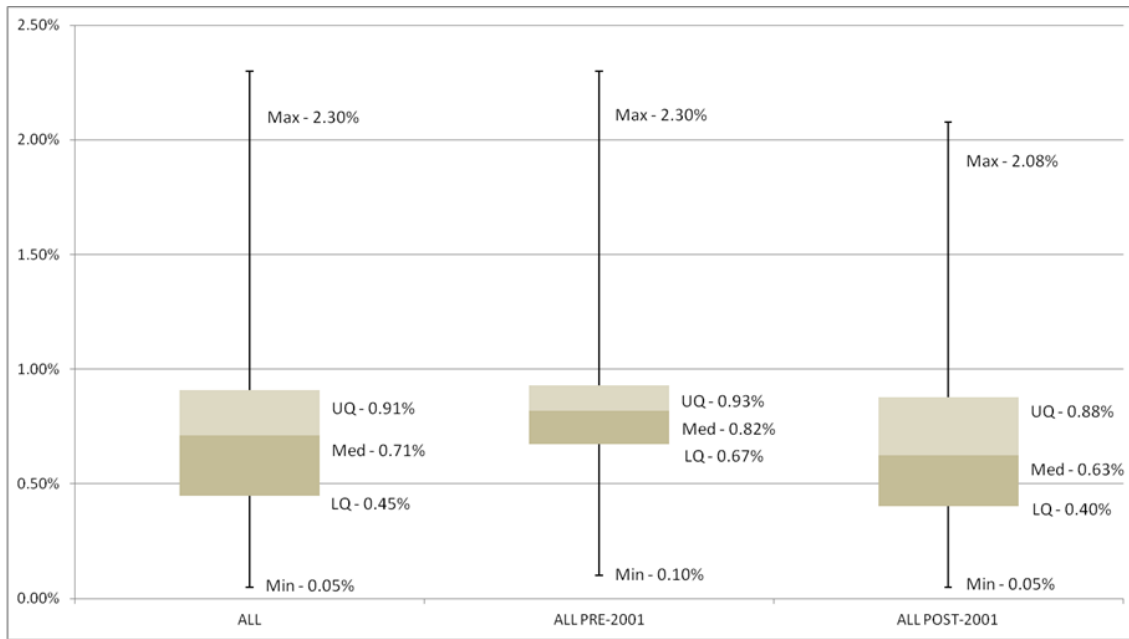
6.12 Assets in schemes set up before 2001, when stakeholder pensions were introduced, tend to have higher AMCs than those set up in 2001 or after. The average AMC for assets in schemes set up pre-2001 is 0.82 per cent compared to 0.63 per cent for schemes set up post-2001 (Figure 6.3).<sup>131</sup>

---

<sup>130</sup> For data availability reasons, providers submitted detailed AMC data only for a subset of the entire DC workplace pensions business, and some providers did not submit detailed AMC data. The OFT's detailed AMC data covers 4.7 million memberships and £94 billion assets under management. This is 70 per cent of the memberships and 82 per cent of assets in the entire OFT sample, which was described in more detail in Chapter 4.

<sup>131</sup> These are medians, as opposed to arithmetic means. The median is the numeric value separating the higher half of a sample, a population, or a probability distribution, from the lower half. The median of a finite list of numbers can be found by arranging all the observations from lowest value to highest value and picking the middle one. 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).

Figure 6.2: Highest, upper quartile, median, lower quartile and lowest AMCs for all contract and bundled-trust based schemes and split by schemes sold before 2001 and after 2001



Source: OFT, based on data submitted by providers

#### Notes:

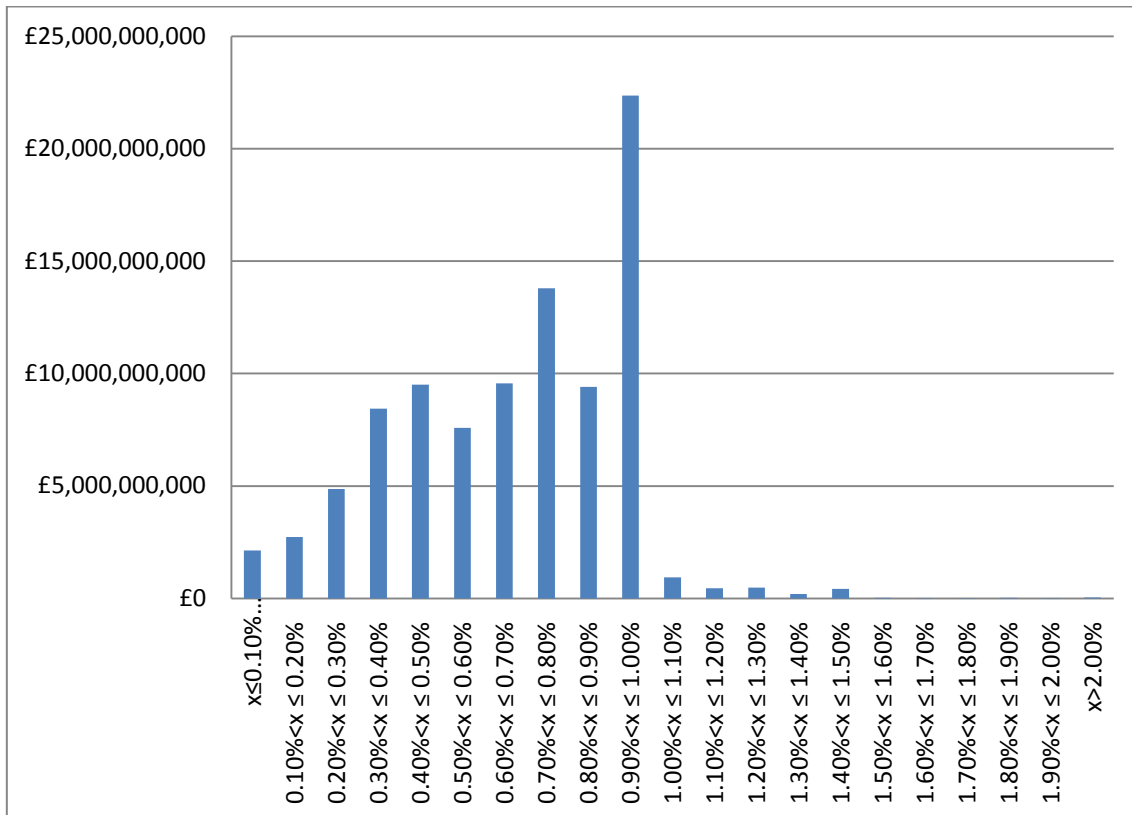
1. This figure shows the maximum, minimum, median, upper quartile and lower quartile AMC across providers' assets under management.<sup>132</sup>
2. It is based on information submitted by a subset of providers that provided detailed responses. In 2013, these providers jointly account for 98 per cent of schemes, 85 per cent of memberships, and 93 per cent of assets in the OFT sample.<sup>133</sup>
3. Providers reported the amount of assets under management in 0.1 per cent AMC bands. The OFT calculated quartiles assuming that assets were uniformly distributed within each 0.1 per cent AMC band.
4. Separately, providers also reported the highest and lowest AMC that they levy in their schemes. There were some differences in methodology across providers which led to some extreme or potentially misleading maxima and minima. These have been excluded from the figure.

<sup>132</sup> The maximum is the highest numerical value in a sample. The minimum is the lowest numerical value in the sample. 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. The lower quartile is the numeric value separating the top three-quarters of a sample, a population, or a probability distribution, from the bottom quarter. The median, upper quartile and lower quartiles of a finite list of numbers can be found by arranging all the observations from lowest value to highest value and picking the middle one, the middle one of the upper half, and the middle one of the bottom half. 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.

<sup>133</sup> As discussed in Chapter 4, it is difficult to gather consistent information on overall market size of the DC workplace pensions market. The OFT sample does not cover the full market, as some market players did not submit their data to us, but the OFT sample is likely to be the most comprehensive available estimate for contract based and bundled trust based schemes.



Figure 6.3: Distribution of AMC for contract and bundled trust-based schemes assets



Source: OFT, based on data submitted by providers

#### Notes:

1. This figure shows the distribution of assets under management by AMC across providers' schemes. Each bar shows the total value of assets within each AMC band.
2. It is based on information submitted by a subset of providers that provided detailed responses. In 2013, these providers jointly account for 98 per cent of schemes, 85 per cent of memberships, and 93 per cent of assets in the OFT sample.<sup>134</sup>

## Competition on charges

6.13 It appears that to the extent that competition on charges takes place in the pensions market it focuses on the level of the AMC – the most visible charge.

<sup>134</sup> As discussed in Chapter 4, it is difficult to gather consistent information on overall market size of the DC workplace pensions market. The OFT sample does not cover the full market, as some market players did not submit their data to us, but the OFT sample is likely to be the most comprehensive available estimate for contract-based and bundled-trust based schemes.

6.14 Whilst competition on charges appears to be applying downward pressure to the AMCs on newer schemes – there are a number of factors that the OFT believes have the potential to weaken price competition, and to prevent some scheme members from benefitting from price competition. These are:

- The lack of comparability of the AMC and the lack of visibility of other charges, costs and expenses levied from a member's pension pot may be preventing competition on overall charges working optimally.
- The rate of switching and the method of individually pricing schemes mean that many pension scheme members may not benefit from falling AMCs on newer schemes.

## AMDs

6.15 The practice of increasing the AMC that members pay when they stop contributing to a pension scheme appears to be a symptom of a lack of competition on charges for those members. The practice of charging different AMCs to active and deferred members prevents any competition on charges on the headline active AMC from benefiting the deferred members of pension schemes. While a scheme member is actively contributing to a scheme they pay a reduced AMC percentage. However, when a member stops contributing to their scheme (that is, when they become 'deferred members'), usually when they leave their employer, the AMC percentage that they pay increases.<sup>135</sup> The industry refers to this charging approach as an AMD.

6.16 AMDs are a relatively recent innovation, offered by seven out of the 13 major providers that provided evidence to us on this. We have identified around 9,800 contract-based schemes containing around £13.4 billion of assets with AMDs.<sup>136</sup> Ninety-four per cent of these schemes are open to AE.<sup>137</sup> On average, the AMC that deferred members pay is 0.47 percentage points higher than those still actively

---

<sup>135</sup> Employees may choose to continue to make contributions into their pension, even after they have left their employer. In these cases, some providers may continue to offer the AMD and levy the lower level of charges.

<sup>136</sup> Approximately 15 per cent of post-2001 contract based schemes surveyed by the OFT have AMDs.

<sup>137</sup> Of these 740,000 members in schemes with AMDs, around 54,000 are already deferred members.

contributing into schemes. The highest reported AMD is 1.00 percentage point. The average AMD (0.47 percentage points) makes a substantial difference to charges - it's a discount of around 50 per cent on the average AMC.<sup>138</sup> We have not received evidence of AMDs being used in bundled or unbundled trusted-based schemes - although it is possible that they may be.

6.17 Some providers have defended their use of AMDs to the OFT. They claim that AMDs could:

- encourage members to save more, because by continuing contributions they might retain their discounted AMC,<sup>139</sup> and
- reduce a potential cross-subsidy between active members and deferred members because active members, who stay at an employer longer, may have larger pension pots and therefore pay more in absolute terms for a given AMC percentage, than deferred members for the same service.<sup>140</sup>

6.18 However, despite these explanations, the OFT has the following concerns about the fairness of AMDs for three reasons:

- AMDs add complexity to charging structures that many scheme members are ill-equipped to cope with or understand. Given scheme members' probable lack of understanding and engagement, we think it possible that many scheme members may be unaware of their charges rising when they stop contributing to a scheme - leaving many of them vulnerable to paying higher charges than they need to
- when employers negotiate these charges we believe they are likely to focus on negotiating the lowest possible charges for 'active' members who are likely to be current employees. There is little incentive on employers to limit the higher charges applied to

---

<sup>138</sup> The OFT makes use of the fact that, according to providers, a 0.01 per cent discount for active members, compared with what the provider would have offered to that employer for a scheme without an AMD, is compensated by a 0.01 to 0.02 per cent increase in the AMC for deferred members. The average AMC for members in schemes with AMDs in the OFT sample is 0.63 per cent, and the OFT calculates that the average deferred member AMC is between 0.87 and 0.94 per cent. Therefore, the average AMD offers active members a discount of between 50 to 54 per cent on the deferred members' AMC.

<sup>139</sup> The OFT note that this practice may be a barrier to switching for members in the individual personal pension market.

<sup>140</sup> The potential for cross-subsidy may be reduced, however, if we consider that deferred members and their pots are likely to cost less for providers to service.

members that have stopped contributing into the scheme, most likely because they have left the employer. Those members who no longer contribute to the scheme will not therefore have anybody actively considering whether their charges still represent value for money and their ability to persuade their former employer to look after their interests is likely to be low, and

- some providers have told the OFT that members who have stopped contributing to schemes cost less for providers to administer than those who continue to contribute. The increase in annual administration charges when an employee stops contributing therefore may not reflect the true cost of administering an employee who has stopped contributing.

## **Transparency and comparability of charges and costs of investing**

6.19 The OFT is concerned that there is currently insufficient transparency and comparability of charges to ensure that competition on costs and charges is working optimally. Buyers of services need to be able to see and compare the charges that they are paying so that they can reach the correct judgments on value for money. We have two particular concerns:

- providers are not including costs and charges within AMCs they quote in a consistent way – which means that the AMCs being quoted by different providers are not easily comparable, and
- AMC figures do not capture all the costs and charges that a scheme member pays, in particular:
  - costs associated with investment management transactions are not included in AMCs quoted by any pension providers
  - pensions sold before the introduction stakeholder pensions have a range of other types of charges in addition to AMCs, including fixed monthly fees, other monthly charges as a percentage of the value of the pension pot, and initial charges levied as a percentage of members' contributions on schemes. This is discussed in more detail at paragraph 6.46.

6.20 The OFT has identified, from submissions received from providers, five broad types of costs that are being paid by pension scheme members, relating to:

- administration of the scheme by the provider
- investment management services
- additional investment management expenses
- adviser payments, and
- costs associated with investment transactions.

6.21 On the basis of the evidence the OFT has collected it appears that providers' administration costs, investment management service costs, and additional investment management expenses are not being consistently included in AMCs:

- Nine out of 13 providers that we gathered evidence from include the entire cost of their internal operations, such as the costs of administering schemes and investment in IT systems, within a single AMC. The remaining four providers either use a different name to refer to these charges, or levy another charge on top of the AMC which contributes to these costs.
- Eight out of 13 providers that we gathered evidence from include the cost of investment management services with a single AMC. For the remaining five providers, they either disclose this component under a different name, or they apply an additional charge. For example, providers may refer to a 'Fund Management Charge', or they may have an AMC and a separate 'External Fund Management Charge'.
- Five out of 13 providers that we gathered evidence from include additional investment management expenses such as legal fees, audit fees and regulatory fees in their headline AMCs. The five providers that include these expenses in their 'AMC' effectively set a fixed fee that includes these costs, without passing on the variation in these expenses. For the remaining eight providers, most

report a retrospective calculation (often called the Total Expense Ratio, or TER) that includes these expenses for the previous year.<sup>141</sup>

#### Adviser payments

6.22 Before the introduction of the RDR at the beginning of 2013, there was substantial variation in the way in which payments to advisers were made and disclosed. Some providers made upfront payments to advisers and intermediaries, and they used various combinations of a higher AMC and/or other separate charges to recover these costs. This meant that headline AMCs were not always directly comparable and may not have captured the total costs.

6.23 The RDR has banned on-going commissions to advisers. It also stipulates that where payments are made to advisers from now on there must be a clear separate charge for payments to advisers, which is not bound up in the AMC and should bring greater consistency.

6.24 The variation in how AMCs are calculated means that the AMCs being quoted by different providers are not easily comparable. This may not confuse employers with access to advice. However, the OFT is concerned that the variation in what 'AMC' means may confuse employers who do not obtain good quality advice, including many employers that will set up pension schemes during the AE period. If AMCs across providers are not easily comparable, this may lead to misleading comparisons, weakening the effectiveness of competition.

#### ABI transparency initiative

6.25 The ABI has developed an Agreement on the disclosure of pension charges and costs. Signatories to the agreement will disclose a 'total charges' figure, which will include:

- provider charges, which covers the costs of administration by providers, any commission paid to an intermediary and, for some providers, the standard investment management charges<sup>142</sup>

---

<sup>141</sup> The TER does not include investment transactions costs, as well as a number of other costs such as the costs of any credit facilities, soft commissions and subscription and redemption charges.

<sup>142</sup> The OFT notes that the potential for varying definitions of the provider charges component of the 'total charges' figure, depending on whether providers include the standard investment management charges, simply

- additional investment management charges, which covers the investment management charges and additional investment management expenses
- adviser charges, if applicable,<sup>143</sup> and
- any other charges, including 'one-off' charges.

6.26 The total charges figure will be disclosed to scheme members in pounds on an annual basis. The ABI state that the Agreement will be implemented by summer 2014 for schemes that have been newly established for auto-enrolment, and by 31 December 2015 for all older workplace pension schemes.<sup>144</sup>

6.27 This ABI initiative is a welcome step which we would encourage all ABI members to adopt as soon as possible. We would however note four areas for further improvement:

- First, we would encourage the ABI to make this single 'total charges' figure disclosable at the point when employers are choosing a scheme, in addition to using the figure for annual reporting to scheme members. This will help employers and employees to make better decisions and help encourage competition on charges. We understand that this is the intention of the ABI.
- Second, we note that the definition of the 'provider charges' component of the 'total charge' figure can vary, depending on whether the provider includes the standard investment management charges. It is important for there to be a consistent definition of what is disclosed in each component part of the 'total charges' figure, and that this is clearly defined.

---

recreates the existing confusion. It is important for there to be a consistent definition of what is disclosed in each component part of the 'total charges' figure, and that this is clearly defined.

<sup>143</sup> At outset, where adviser remuneration is contained within the core charge (that is, via commission) it will be included in the total charges figure. In less common cases where adviser remuneration is not included in the core charge and/or is presented as a pounds figure (for example, use of Adviser Charging or Financial Adviser's Fee), it will be clearly and separately disclosed in the key features illustration as required by the FCA.

<sup>144</sup> ABI, Agreement on the disclosure of pension charges and costs. Available here: [www.abi.org.uk/Insurance-and-savings/Products/Pensions/ABI-agreement-on-pension-charges-and-costs](http://www.abi.org.uk/Insurance-and-savings/Products/Pensions/ABI-agreement-on-pension-charges-and-costs)

- Third we would question whether 'total charges' is an appropriate final name for the figure given that it would not include investment transaction costs.
- Finally, the OFT notes that these initiatives are currently voluntary and that not all market participants are members of these industry associations.<sup>145</sup>

## Investment transaction costs

6.28 Investment transaction costs are not included in AMCs levied by any provider.<sup>146</sup> They are usually deducted from members' pension funds directly, so they are implicitly reflected in the unit price or performance of the underlying investments of members' pensions. Transaction costs include:

- commission paid to the broker when a transaction is carried out
- bid-offer spreads – the difference between the price received when you sell a financial product (the bid price) and the price paid when you buy it (the offer price). This 'spread' creates a profit for the 'market maker'
- bank transaction charges
- foreign exchange fees associated with the transaction, and
- any local taxes (including UK stamp duty).

6.29 Unlike the other costs and charges described in paragraphs 6.20-6.24, these transaction costs are less predictable. The number of transactions carried out in a given year will vary depending on market conditions, the rate at which assets are changed within the fund which may depend on whether it is a passive or active fund, and the judgments the investment manager makes.

6.30 Investment managers and providers have told the OFT that while attempting to include these costs within a fixed AMC might increase the visibility and certainty of investment transaction charges, it would

---

<sup>145</sup> A list of signatories to the Agreement can be found here: [www.abi.org.uk/News/News-releases/2013/01/pension-charges-to-be-made-clearer-to-uk-savers.aspx](http://www.abi.org.uk/News/News-releases/2013/01/pension-charges-to-be-made-clearer-to-uk-savers.aspx)

<sup>146</sup> They are also not included in the TER.



create the incentive to avoid carrying out transactions in order to keep costs within an overall AMC limit, even where this is contrary to the member's interests. They also point out that investment transactions do not necessarily reduce returns despite the costs associated - if an investment manager makes effective investment decisions, a transaction should have a positive impact overall on a scheme member's investment returns. They underline therefore that historic transaction costs may not be an effective indicator of the future impact on the performance of pension investment.

6.31 Others have told the OFT if these costs are excluded from the visible AMC, that this may create an incentive for the investment manager to 'churn' the portfolio- particularly where the investment manager is part of a vertically integrated pension provider that provides its own investment management and execution services for which it also charges separately in addition to the services for pension provision. They argue that this is because the investment management operation may in certain circumstances accrue some benefits in relation to certain transactions.

6.32 We agree that fixing investment transaction costs within an AMC could limit the flexibility that investment managers have in pursuing transactions that are in scheme members' interests. Attempting to include transaction costs within the AMC could also undermine the objective of achieving a simple and consistent AMC breakdown. For these reasons we would not seek to include investment transactions costs within a standardised AMC or total charges figure.

6.33 Nevertheless, we consider that it is important to improve the visibility of investment transaction costs according to a consistent reporting methodology. In particular, although we have not received comparable and comprehensive data on levels of transaction costs, we are concerned that the quantum of investment transaction costs for some funds may be significant - particularly in funds with high turnover rates. Visibility is an important part of securing greater competitive pressure on investment transaction costs. While this competitive pressure may not come from individual scheme members or their employers, we do consider that the providers, Independent Governance Committees and scheme trustees should be well placed to

challenge investment transaction costs.

#### Current IMA and FCA initiatives

6.34 The Investment Management Association (IMA) 'Enhanced disclosure of fund charges and costs', issued in September 2012, sets out the IMA's expectations of enhanced disclosure of costs and charges to investors, and includes provisions for disclosing the policies and procedures for monitoring transaction costs and assessment of their impact.

6.35 Finally, the OFT also notes the FCA's announcement in its business plan that it intends to undertake work on charging structures in investment management this year.<sup>147</sup>

### **Individual pricing of schemes and the competitive impact of switching**

6.36 Pensions providers have told the OFT that the charge that providers are willing to offer employers depends on how much revenue providers expect the scheme to generate for a given level of AMC, compared with how much they expect it to cost to service the scheme.

6.37 The revenues derived from a scheme depend on the size and growth of the assets under management,<sup>148</sup> which in turn depend on the employers' and members' characteristics, including:

- average contribution per member – where the higher the average amount that the employer and members regularly pay into each member's pension, the lower the potential AMC

---

<sup>147</sup> FCA Business Plan 2013/14, p.16 " In 2013/14 we will undertake a project that will highlight the behaviours and practices of asset management firms in relation to charging structures that harm consumers. Initial evidence suggests that fund fees are high in the UK compared to comparable markets and charging structures do not promote informed consumer choice" and p.18 " In 2013/14 we will also review the management of conflicts of interest in the asset management sector." Available here: [www.fca.org.uk/your-fca/documents/business-plan/bp-2013-14](http://www.fca.org.uk/your-fca/documents/business-plan/bp-2013-14)

The FCA wrote to 11 fund groups in August 2013 as part of a thematic review into fund charges. [www.investmentweek.co.uk/investment-week/news/2289181/fca-writes-to-asset-managers-as-part-of-fund-charges-review](http://www.investmentweek.co.uk/investment-week/news/2289181/fca-writes-to-asset-managers-as-part-of-fund-charges-review)

<sup>148</sup> The tendency for schemes with higher assets under management to receive lower AMCs is also illustrated in Figure 6.1 above.

- transfer value of existing assets – where the larger the amount of money that will be transferred from an existing pension to the new scheme, the lower the potential AMC
- average time until retirement – where the longer the amount of time providers can generate revenue from members' accumulated savings the lower the AMC that providers might be willing to offer
- scheme persistency - where the longer a provider expects a scheme to stay with that provider before switching, the lower the AMC that providers might offer, and
- number of members - where the larger the number of members then, for a given average contribution per member, the larger the total assets under management over which providers can spread the fixed costs of setting up and running a scheme, and the lower the AMC it might offer.<sup>149</sup>

6.38 Most providers have told us that they are likely to set a higher AMC for schemes that cost more to service. In terms of expected costs, evidence submitted by providers indicates that pension providers incur relatively high upfront costs when they set up the scheme and lower ongoing costs when running the scheme - although schemes with a higher staff turnover are likely to have higher administrative costs per member on an ongoing basis, and schemes with a higher number of members will have higher total ongoing administrative costs for the provider.

6.39 However, whilst cost of administering schemes across employers in the factors set out above may explain some of the variation in scheme AMCs, the OFT considers it unlikely that the variations in AMC are fully explained by these differences.

6.40 This is because most providers set an individual charge for each scheme.<sup>150</sup> Employees who have a workplace pension with the same

<sup>149</sup> Although note that schemes with more members are also likely to have higher total ongoing administrative costs.

<sup>150</sup> There are some exceptions. B&CE, NEST and NOW:Pensions all levy the same charges for all employers. NEST has a Public Service Obligation to offer the same charges to everyone. For B&CE and NOW:Pensions, it is unclear whether they reserve the right or have the ability to charge different rates to different employers in future, if they wanted to do so.

provider through different employers, even if all employer and member characteristics were the same, could pay a different charge depending on how well their particular employer had negotiated a charge with the provider.

6.41 Scheme members are therefore unlikely to benefit from AMCs falling on newer schemes unless their employer opts to switch provider or to use the threat of switching to re-negotiate terms. The OFT estimates that the average annual rate of switching is around 3.6 per cent of schemes and 6.7 per cent of assets,<sup>151</sup> and the average annual rate of employers successfully re-negotiating improvements to overall terms without switching is around 0.4 per cent of schemes and 3.6 per cent of assets.<sup>152</sup> Given the current rate of switching and the renegotiation of terms in the market there appears to be an insufficient threat of switching for providers to unilaterally lower scheme AMCs to make charges more cost reflective (particularly for older schemes, as discussed in the next section).

## **Higher charges on pre 2001 schemes**

6.42 The difficulty of comparing costs and charges of older schemes with newer schemes, the way that schemes are individually priced and the level of switching in parts of the market have all contributed to around £30 billion of contract and bundled trust based schemes (approximately one quarter of the total assets in schemes) being left with charges that are at risk of being out of step with the levels of charges on newer schemes. The weak buyer side (as discussed in Chapter 5) and other barriers to switching (discussed in Chapter 4), appear to be contributing to a lack of competitive pressure on charges for these older schemes. There is a risk that providers market power over this segment of the market keeps AMCs higher relative to what it may cost to service them.

---

<sup>151</sup> These rates are based on data submitted by providers, who jointly account for 78.0 per cent of schemes and 74.9 per cent of assets under management in the whole OFT sample on 1 January 2013. The OFT estimates are obtained by dividing the number of schemes and assets these providers won by the total schemes and assets of these providers each year, and taking an average over the period 2009 to 2012.

<sup>152</sup> According to data submitted by providers, who jointly account for 48.8 per cent of schemes and 38.0 per cent of assets under management in the whole OFT sample on 1 January 2013, the OFT estimates are obtained by dividing the number of successful schemes and assets by the total schemes and assets of these providers, and taking an average over the period 2010 to 2012.

6.43 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.<sup>153</sup>

6.44 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.<sup>154</sup>

6.45 The OFT has constructed a model to estimate the additional charges that current members of pre 2001 schemes would pay compared to members of post-2001 schemes on average.<sup>155</sup> Based on this model

---

<sup>153</sup> This average is calculated on the basis of scheme charges on 1 January 2013. The difference of 0.16 percentage points is based on the arithmetic mean AMC of pre- and post-2001 schemes (0.79 per cent for pre-2001 and 0.63 per cent for post-2001), rather than the median AMC (0.82 per cent for pre-2001 and 0.63 per cent for post-2001) reported in paragraph 6.12 and Figure 6.2. For any given set of individual circumstances, someone with an average pre-2001 pension can expect to pay 26 per cent more in AMC than with an average post-2001 pension.

<sup>154</sup> From the OFT sample, 22,886 schemes set up pre 2001 are open to AE and are accepting new members. This equates to 25.6 per cent of the current schemes in the market that are open to AE and accepting new members.

<sup>155</sup> This estimate is based on a number of modelling assumptions. These are:

- Starting pot, £20,000 (average pot of pre-2001 members, from OFT analysis of detailed AMC data from providers)
- Number of pre-2001 memberships, 1,377,000 (sum of pre-2001 members, from OFT analysis of detailed AMC data from providers)
- Starting salary, £26,500 (median earnings from, ONS Annual Survey of Hours and Earnings, 2012 found here: [www.ons.gov.uk/ons/dcp171778\\_286243.pdf](http://www.ons.gov.uk/ons/dcp171778_286243.pdf)),
- Annual real growth in earning, 2 per cent (approximate long run growth in real earnings over the last 25 years, found here: [www.ons.gov.uk/ons/dcp171776\\_286266.pdf](http://www.ons.gov.uk/ons/dcp171776_286266.pdf)),
- Employee contribution, 2.7 per cent (average in 2010, ONS pension trends, 2012 edition, Chapter 8, found here: [www.ons.gov.uk/ons/dcp171766\\_270207.pdf](http://www.ons.gov.uk/ons/dcp171766_270207.pdf)),
- Employer contribution, 6.2 per cent (average in 2010, ONS pension trends, 2012 edition, Chapter 8, found here: [www.ons.gov.uk/ons/dcp171766\\_270207.pdf](http://www.ons.gov.uk/ons/dcp171766_270207.pdf)),
- Government contribution is 20 per cent of combined employee and employer contributions,
- AMC (pre-2001), 0.78 per cent (average from OFT analysis of detailed AMC data from providers),
- AMC (post-2001), 0.62 per cent (average from OFT analysis of detailed AMC data from providers),
- Starting age, 41 years (average working age of the UK population, ONS Statistical Bulletin, Labour Market Statistics, June 2013, found here: [www.ons.gov.uk/ons/dcp171778\\_312067.pdf](http://www.ons.gov.uk/ons/dcp171778_312067.pdf)),
- Retirement age, 63 years (average retirement age in the UK, ONS Statistical Bulletin, Labour Market Statistics, June 2013, found here: [www.ons.gov.uk/ons/dcp171778\\_312067.pdf](http://www.ons.gov.uk/ons/dcp171778_312067.pdf)),
- Time as active member, five years,
- Assumed real portfolio growth rate, five per cent (Intermediate growth rate from Appendix 2 of FCA COBS 13),
- Present value of charges discounted by annual rate of return, five per cent.

Importantly, this estimate assumes that after five years all members transfer to a post-2001 scheme but their existing pot remains and continues to grow. It also implicitly assumes that no new members transfer into pre-2001 schemes. The estimate is sensitive to changes in the assumptions. Most obviously, it is sensitive to changes in assumption about the ages and therefore the time until retirement for members in the pre-2001 schemes. This is because where people have a shorter period to retirement they will have fewer payments to make and there will be less time for their pots to grow (although these factors will be to some extent counterbalanced by the fact that for these people their pot is likely to be larger). There may be reason to believe that the average age of people in pre 2001 schemes, particularly the closed schemes, is higher on average than the general working populations.

the OFT estimates that the 1,377,000 members of these legacy scheme will together pay an additional £1.9 billion in AMCs over the remaining lifetime of their pensions schemes.<sup>156</sup> At current values this works out to be equivalent to an additional annual payment of approximately £50 per member per year in real terms.

6.46 However, many of the schemes sold before 2001 also have other additional charges, such initial charges on contributions and other fixed charges that are regularly levied on members. Our analysis of information provided by pension providers indicates that there are at least four additional types of charge on pre 2001 schemes:<sup>157</sup>

- Initial or contribution-based charges – these charges involve a deduction from the contributions that is actually invested into their pension fund.<sup>158</sup>
- Ongoing fixed charges – these charges can be levied on an ongoing basis.<sup>159</sup> For example many pre 2001 schemes charge a fixed amount per month for each member.
- Discontinuance or early surrender penalties – these charges involve a one-off penalty being levied on members if they either stop regular contributions or prematurely withdraw funds. This may occur when employees change jobs, or if they want to transfer their savings to another provider. The level of exit charge is typically calculated as a proportion of the first few years of contributions into the scheme.
- Other one-off charges – these charges are levied when triggered by certain events. For instance, they can be levied when members switch funds or change the level of their regular contributions.

---

<sup>156</sup> As a robustness check, we also report the most conservative estimate of additional charges, which ignores the impact of investment growth over time on the size of the pot and, therefore, charges. Approximately 1.4 million memberships are in pre-2001 schemes in the part of OFT sample with detailed information on AMCs, with an average pot size of approximately £20,000 each. The difference in mean AMC for pre-2001 and post-2001 schemes is 0.16 per cent. This gives an annual aggregate difference in charges of approximately £43 million, or around £32 per member per year.

<sup>157</sup> The OFT note that there is a wide variation in terminology across different providers for each of these types of charges and their instances. Furthermore, each of these charges are calculated and levied in many different ways.

<sup>158</sup> Ten per cent of schemes in the OFT sample, with three per cent of memberships and three per cent of assets, have initial charges. Although most post-2001 schemes do not have initial charges, NEST is a recent and prominent exception, as it levies a 1.8 per cent initial charge.

<sup>159</sup> Five per cent of schemes in the OFT sample, with one per cent of memberships and one per cent of assets, have exit charges. Although most post-2001 schemes do not have initial charges, NOW: Pensions is a recent exception, as it levies a £1.50 per month administration charge for each member.

6.47 Pension providers have not been able to provide sufficient data to quantify the additional impact of these charges in the course of the market study. Providers have told us that these additional charges on 'legacy' schemes are levied in many different ways and often depend on each individual member's circumstances.<sup>160</sup>

6.48 Providers have told us that some of these 'legacy' schemes may also have additional benefits that schemes sold post 2001 do not have. This may have made it more difficult for employers or advisers to assess whether members will benefit from switching to a more modern scheme with lower charges but which do not provide these additional benefits.<sup>161</sup>

6.49 The OFT is aware of four broad categories of legacy scheme features which may in some cases justify the higher charges and provide value for money overall, compared with more modern schemes.

- Guaranteed annuity options or rates, also known as income guarantees – some schemes have a guaranteed minimum rate at which the scheme member can use their accumulated pension savings to purchase an annuity with a provider. Some providers have told us that, at the time of writing in June 2013, some members with guaranteed annuity rates could purchase an annual income that is double to what they could get at the prevailing open market rates.
- Guaranteed rates of return or fund value at a selected date, also known as cash guarantees – cash guarantees provide certainty over the minimum value of members' accumulated savings, usually in

---

<sup>160</sup> For this reason, the OFT has not been able to calculate an overall or average level of initial charges and exit charges. On the prevalence of these charges, according to data from providers, 10 per cent of schemes in the OFT sample, with three per cent of memberships and three per cent of assets, have initial charges. Similarly, five per cent of schemes in the OFT sample, with one per cent of memberships and one per cent of assets, have exit charges. The vast majority of these are in schemes which are not going to be used for AE or which are closed to new members. This is consistent with what providers have told us, when they re-structured most of their schemes in 2001 as a response to the introduction of stakeholder pensions. This is based on information submitted by a subset of providers that provided detailed responses. In 2013, these providers jointly account for 98 per cent of schemes, 81 per cent of memberships, and 87 per cent of assets in the OFT sample.

<sup>161</sup> This is supported by the FCA. In June 2013, the FCA issued guidance on unacceptable outcomes of advice on transferring existing assets, which includes switching that involve extra product costs or loss of benefits from the existing scheme without good reason. FCA, FCA article Pension switching, 2013. Available here: [www.fca.org.uk/firms/financial-services-products/investments/pension-switching](http://www.fca.org.uk/firms/financial-services-products/investments/pension-switching)

exchange for explicitly higher charges or implicitly lower investment returns. For example, providers may guarantee that the value of members' assets will increase at a minimum rate per year.

Alternatively, they may guarantee that the value of a member's assets will be at least a certain amount at retirement. These benefits are relatively prevalent in pre 2001 schemes (see Table 6.1). However one provider has indicated to us that overall growth in the stock market, since many of these products were purchased, means that the guarantee is unlikely to increase payouts at present.

- Other forms of bundled insurance - pre 2001 schemes may sell various kinds of insurance together with a pension. The two most prominent examples are: incapacity insurance, for which the provider promises to pay the member's regular pension contributions in certain circumstances such as incapacity or illness, and life insurance, for which the provider promises to pay an additional defined lump sum to the member's dependents in the event of death before retirement, in exchange for higher charges.
- Loyalty bonuses, also known as fund value rebates or fund charge rebates – these bonuses reward members if, for example, they have remained with a provider for a certain amount of time, or once the value of assets in their fund reaches a certain level.

6.50 However, based on the data received from pension providers, these additional benefits do not appear to apply to the majority of assets in 'legacy' schemes (See table 6.1). It is not, however, possible for the OFT to estimate their overall value for scheme members. In order to understand this, the OFT would need data on, among other things the employee's risk preferences, their time until retirement, the value of their accumulated savings, and current and expected future market conditions.



**Table 6.1: Additional benefits associated with legacy schemes**

<b>Legacy Benefit</b>	<b>Per cent of pre 2001 schemes</b>	<b>Per cent of pre 2001 assets</b>
Income Guarantees	5 per cent	2 per cent
Loyalty Bonus	9 per cent	4 per cent
Cash Guarantees	75 per cent <sup>162</sup>	28 per cent
Other insurance	8 per cent	5 per cent

Source: OFT, based on data submitted by providers

**Notes:**

1. This table shows the OFT's estimates of the prevalence of the four categories of benefits that apply to some pre 2001 schemes but to schemes sold post-2001.
2. It is based on information submitted by providers that jointly accounts for 71 per cent of schemes, 63 per cent of memberships, and 67 per cent of assets in the OFT sample.<sup>163</sup>
3. Providers submitted the total number of schemes, memberships and assets that these benefits apply to. The OFT compared these with providers' total number of pre 2001 schemes, memberships and assets that these providers administer.
4. These figures should be interpreted with caution, as they could overestimate the prevalence of these legacy benefits. This is because there may be double-counting where a single scheme or member enjoys multiple benefits within the same category; say for instance, different kinds of cash guarantees.

6.51 Overall, the extent to which an individual may benefit from switching to a more modern pension, that may have lower charges, will depend on how the new charging structure compares to the current one, including any current or future potential discounts or bonuses and any additional features it may offer or which may be lost as a result of switching.

## **Conclusions**

6.52 Based on the evidence we have gathered it appears that competition may be playing a role in ensuring that the average AMC on new contract based schemes and bundled trust based schemes is falling for newer schemes. However, many scheme members are not benefiting from this downward trend.

---

<sup>162</sup> Although it applies to a large proportion of schemes, the number of members who benefit from this are still relatively low implying the benefit is not that widespread.

<sup>163</sup> As discussed in Chapter 4, it is difficult to gather consistent information on overall market size of the DC workplace pensions market. The OFT sample does not cover the full market, as some market players did not submit their data to us, but the OFT sample is likely to be the most comprehensive available estimate for contract-based and bundled-trust based schemes.

6.53 AMDs significantly increase the AMC paid by 'deferred' or former scheme members that have stopped contributing to a pension scheme and undermine the potential for future price competition on their charges. This is leading to these 'deferred' or former scheme members paying an AMC of 0.47 percentage points more on average than active members. The OFT is recommending that deferred or former members of DC workplace pension schemes should not be penalised in respect of the charges they pay in comparison to those scheme members that continue to actively contribute into that scheme (see Chapter 9).

6.54 The lack of comparability of the AMC, and the lack of visibility of other charges that are not included within the AMC, make comparisons difficult and prevent competition on overall charges from working optimally. The OFT is recommending that all charges and costs associated with pension schemes, with the exception of investment management transaction costs, should be disclosed as a single charge to allow employers to be able to compare more easily between different the charges. We do not, however, believe that fund management transaction costs should be included in this charge because in some cases this might incentivise fund managers to avoid trading that would otherwise be in the scheme members' interests (Chapter 9). Transaction costs should be clearly disclosed, in the interest of transparency and understanding pension costs, but should not form part of the single charge agreed at outset.

6.55 The rate of switching and the method of individually pricing schemes mean that unless an employer opts to shop around for a new scheme its scheme members will not benefit from falling AMCs on newer schemes. A weak demand side for many schemes, particularly for older ones, means that providers may not face competitive pressure to lower charges for these schemes. Given that developments in the market, and in particular the RDR (see paragraphs 8.11 to 8.18 for further consideration of its potential impact), mean that in future switching might fall further, we have focused on developing a recommendation on strengthening scheme governance in order to supplement the weaknesses in the demand side of the market.

## **7 QUALITY**

### **Introduction**

- 7.1 In recent years there has been considerable media focus on the level of costs and charges levied on members' work based pension schemes. However, as many pension providers, advisers and regulators have told the OFT, the quality of the service that an employee receives in exchange for the charges they pay is an equally important element of value for money.
- 7.2 This chapter assesses whether competition can be relied upon to drive up the quality of each of the key elements of a good pension product: the administration of the scheme, the design and execution of the investment strategy, and the governance of the scheme. All of these elements are important in determining the size of members' pension schemes.
- 7.3 Overall, we find that weaknesses in the demand side of the market and the challenge for many employers and employees in assessing and comparing quality make it very difficult to generate competition on these elements.

### **Elements of scheme quality**

- 7.4 Based on the views expressed by market participants, TPR and the DWP, the OFT considers that there are 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 costs and losses on members,

and administration costs in bundled schemes usually make up a significant proportion of the overall charge paid by members,<sup>164</sup>

- 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 that those funds remain suitable and continue to deliver value for money.<sup>165</sup> It is crucial that the design and implementation of the default investment strategy is as far as possible tailored to the level of risk and return that is appropriate for scheme members, and
- 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. It 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, which, as set out in Chapter 5, is often weak. Scheme governance has been included in the quality section of the report because, for both contract and master trust based schemes (the two types of schemes that employees are most likely to be automatically enrolled into), it is a service that is paid for by scheme members. However, we also note that for single trust based schemes governance is provided by boards of trustees which are set up by the employer. These usually have a specific requirement for representation to include employee representatives or an independent trustee to manage any conflicts of interests.

7.5 The rest of this chapter goes through the three identified elements of quality and assesses whether, in light of the weaknesses on the buyer side of the market set out in Chapter 5, competition can drive good quality standards.

---

<sup>164</sup>In unbundled trust based schemes, the costs of administration for current scheme members are often paid by the employers.

<sup>165</sup> A small number of members are expected to self-invest under AE.

## Competition on quality of administration and member communications

- 7.6 Administration and communications are important elements of a good quality pension scheme. Administrative errors can lead to significant costs and losses to scheme members and potentially significant distress as well.<sup>166</sup> Good member communications and engagement tools can help members make more informed decisions, be more engaged with their pensions and can encourage them to keep track of whether they are saving enough to reach their target income upon retirement (see Chapter 5).
- 7.7 Further, administration and communications costs can constitute a large proportion of the AMC paid to the provider by members. We were told by providers that scheme administration costs could make up between 85 and 95 per cent of the AMC in bundled trust based and contract schemes.<sup>167</sup>
- 7.8 The Pensions Advisory Service told us that most complaints they receive from employees are about administration. These include complaints about delays in paying benefits, delays in transferring assets between schemes, delays in the scheme paying out on retirement and employers paying contributions that are too low. This may suggest that members are able to recognise when administrative mistakes have been made and can take steps to remedy such errors, although it is impossible to know how many of these errors go undetected.
- 7.9 However, while there is some evidence that problems with administration may eventually come to light, the OFT is nevertheless concerned that employers and trustees are not applying competitive pressure to raise the quality of administration for two main reasons:

- Quality of administration is difficult to assess, both at the point of sale and on an ongoing basis. As set out in Chapter 5, the OFT

---

<sup>166</sup> For example, TPR refers to Experian research which has shown that if records are validated, meaning records are up to date and errors corrected quickly, the potential savings could be as much as £20,000 per pensioner. TPR, The importance of good scheme administration, February 2011. Available at: [www.thepensionsregulator.gov.uk/docs/scheme-administration-statement-feb-2011.pdf](http://www.thepensionsregulator.gov.uk/docs/scheme-administration-statement-feb-2011.pdf)

<sup>167</sup> This applies to default investment strategies that mainly use passive funds, such as equity trackers.

found that pre-sale information on the performance of administration services against service level agreements is not always consistently provided. As a result, the OFT is concerned that employers will, without access to an adviser, find it difficult to judge the quality of administration services from the pre-sale information received from product providers. Even once a scheme is set up, running errors may not emerge immediately or indeed at all.

- Barriers to switching in both contract and trust based schemes may prevent employers from leaving underperforming administrators. Bundling of investment management and administration services in master trust and bundled trust based providers may act as a deterrent to switching where only scheme administration is underperforming. Further, in the unbundled trust based market, TPR has expressed concerns about the barriers to schemes switching administrators. We have also become aware of concerns about barriers to switching between third party administrators, for example, in the form of exit fees and difficulties in ensuring that the administrator hands over the data to the incoming administrator effectively. The Pensions Administration Standards Association (PASA)<sup>168</sup> has acknowledged this problem and has now launched a draft a code of conduct for administrator transfers.<sup>169</sup>

7.10 These concerns about competition may be contributing to the following potential problems with the quality of scheme administration:

- Administrative standards across all schemes. We have been told that the focus of competition on the AMC (as set out in Chapter 4 and 6) may lead to providers lowering administration standards in order to maintain a profit margin. This could be a particular issue in closed schemes where the employers and trustees are not scrutinising the scheme.
- Administration standards in closed schemes. As set out in Chapter 5, employers and trustees may not have the incentives to closely

---

<sup>168</sup> PASA sets standards for pension administration and providers, publishes guidance and assesses compliance with those standards.

<sup>169</sup> [PASA website, PASA launches Code of Conduct on Administration Provider Transfers 2013](http://www.pasa-uk.com/26/122/pasa-launches-code-of-conduct-on-administration-provider-transfers), Available here: [www.pasa-uk.com/26/122/pasa-launches-code-of-conduct-on-administration-provider-transfers](http://www.pasa-uk.com/26/122/pasa-launches-code-of-conduct-on-administration-provider-transfers).

scrutinise closed schemes, particularly if scheme members have already left the employer. Based on the data received by the OFT, there are at least £24.5bn worth of assets in closed contract based and bundled trust based schemes, which is 22 per cent of the assets of the providers who responded to the OFT.<sup>170</sup> We have also heard that members of trust based schemes that leave the employer or decide to stop contributing can find themselves in schemes with similar issues after a 'Section 32 buyout'.<sup>171</sup>

- Administration standards in smaller trust based schemes. TPR has identified concerns about the quality of smaller trust based scheme administration. For example, in its most recent record keeping survey TPR found that many schemes - mostly small schemes - have yet to meet TPR's record-keeping standards.<sup>172</sup> TPR attributes this to a number of factors including low levels of trustee capability, lack of trustee understanding and engagement and resource constraints on smaller trust based schemes.
- Potential for low administration standards and lack of switching where the administration provider is conflicted. The OFT has identified two business models with potential conflicts of interest. First, some market participants were concerned that where a master trust's trustee board has been appointed by a provider which also provides administration it seems unlikely that trustees will switch to a different administrator if their existing one is underperforming. In some cases, the trust rules may even prevent the trustees from being able to change the service providers. Second, advisers that provide both advice and administration services are not likely to recommend that employers switch to a different administrator if their services no longer provide value for money.

---

<sup>170</sup> We also found that 76 per cent of members in these schemes are 'deferred', so most likely have already left the employer and are not engaged with the performance of their pension. This data was received as part of the OFT's request for information, and includes data on both contract based and bundled trust based schemes.

<sup>171</sup> Section 32 of the Finance Act 1981. This allows trustees to absolve themselves of their fiduciary duties towards members who have stopped contributing towards schemes. The scheme member's existing pot is then bought by a contract based provider and managed in the same way as a personal pension.

<sup>172</sup> TPR, Scheme record keeping survey, 2013. Available here: [www.thepensionsregulator.gov.uk/docs/scheme-record-keeping-2013.pdf](http://www.thepensionsregulator.gov.uk/docs/scheme-record-keeping-2013.pdf)

## Quality of investment propositions and performance

7.11 The quality of a scheme's investment proposition depends on the following two factors:

- The design of the investment strategy. Investment strategies should aim to generate returns at a level of risk that is acceptable for members over time and is appropriate to the circumstances of scheme members.<sup>173</sup>
- How the investment strategy is executed and the investment performance achieved. The performance of investments is affected by the value for money of funds chosen to execute the strategies.<sup>174</sup>

7.12 In the course of our work, we have focused on assessing the extent to which competition can ensure and improve the value for money of investment propositions offered in the market, by providing good quality investments at a competitive price. As part of our consideration of investment quality, however, we have not attempted to gather and assess data on long term investment performance of particular investment strategies and funds or discuss the value for money of passive investment strategies relative to active ones. This type of assessment can be influenced by unpredictable fluctuations in financial markets, and would have to take into account differences in scheme member profiles and strategies used by different schemes. Further, extensive academic research also indicates that past performance is not a good predictor of future fund performance. Therefore, the OFT considers that there was little value to be gained from trying to undertake a detailed assessment of historic underlying investment quality within the time constraints of this market study.

---

<sup>173</sup> The factors to consider when assessing whether the default is suitable to members include: how close they are to retirement, their risk appetite (though members may not always be informed enough to make unbiased judgments about their risk appetites), whether members have other assets (for example, property), salary levels etc. The current best practice is to gradually reduce the level of short-term risk that members' pensions are exposed to as they approach retirement, and hence some de-risking glide-path is necessary.

<sup>174</sup> Member savings are also affected by the costs of asset management that are not included in their AMC. These costs are incurred at the asset management level of the supply chain and are usually deducted from member's funds. The FSA's recent work on conflicts of interest in asset management highlighted some cases where these costs may not be managed effectively or in the interests of investors. For example, the FSA found that asset managers did not adequately control spending, research or execution services (see FSA, Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks, 2012. Available at: [www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf](http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf)). The FCA is also currently undertaking a review of conflicts of interest in unit-linked funds, which are often used in insurer-provided DC pension schemes. While the OFT appreciates the importance of these issues, it has not considered these further as part of this market study. This is because the issues in asset management affect other markets, not just pensions, and there is ongoing FCA work on this topic.



7.13 Employees are unlikely to drive competition on investment quality.

Although most employees have the option to choose the make-up of their investment strategy and choose between the funds provided by the scheme, most do not do so. According to AE rules, all scheme members will be automatically enrolled in a scheme's default option, from which they can opt out. If they choose to opt out of the default, they will need to choose their own funds to invest into. Most members are expected to be automatically enrolled and remain in the default investment strategy due to inertia, lack of understanding and ability, or because they treat it as a recommendation. Furthermore, a recent study looking at people approaching retirement found that 77 per cent of individuals in their 50s and 60s did not know what their pension fund is invested in, and 71 per cent had no idea about how their pot was performing, which suggests that most employees are not actively reviewing the performance and quality of their investments.<sup>175</sup>

7.14 Based on evidence received from providers there appear to be differences between how competition on investment quality works now and how it is likely to develop in the context of AE, particularly in the SME segment of the market. Whereas up to now providers have competed to offer employers bespoke default investment strategies which meet their employees' risk profiles, in the context of AE, providers expect competition to become more focused on different off-the-shelf default investment strategies, particularly as smaller employers enter the market. Provider submissions indicated they have developed a new suite of off-the-shelf default options specifically for AE.

7.15 Focusing on a smaller number of default investment strategies may make it easier for employers to compare between them. Nevertheless, the OFT is concerned that it will be very difficult to generate competition on the quality of the default investment design and performance in the unadvised segments of the market or where advisers are not involved in scrutinising default options, for the following reasons:

---

<sup>175</sup>Financial Times article, Pensions savers unaware of investment performance, 14 August 2013. Available at: [www.ftadviser.com/2013/08/14/pensions/pension-savers-unaware-of-investment-performance-clt5gxAi9PFIhD3uoEocZK/article.html](http://www.ftadviser.com/2013/08/14/pensions/pension-savers-unaware-of-investment-performance-clt5gxAi9PFIhD3uoEocZK/article.html)

- The differences between the investment strategies of the default options available in the market are difficult to assess and compare without investment management expertise.<sup>176</sup> What is the best investment strategy is currently subject to much debate, though there is consensus that some type of de-risking that reduces exposure to risk as the individual ages is desirable for the default option. Indeed, in-depth academic studies on the subject have compared various default investment strategies without being able to reach conclusive results.<sup>177</sup>
- It is also difficult to reach judgments about the execution of the investment strategy. When the scheme is initially selected, the future investment performance is unknown. However, even once there is data available on the scheme's performance, to make a meaningful assessment is very complicated as past performance is not necessarily a guide to future returns.

7.16 We have been made aware of concerns about advisers offering their own investment management services, such as designing and managing default investment strategies. Where they also provide advice on scheme design, such advisers may have conflicting interests.<sup>178</sup>

7.17 We also note that providers and investment managers have agreed with our view that investment quality is difficult to assess and believe that this has focused competition on minimising the AMC. Providers thought that as a result, more expensive strategies that may have

---

<sup>176</sup> The OFT has reviewed the emerging propositions and providers' largest default funds, and has concluded that the main differences are around differences in glide-paths (for example, how many years before retirement assets are moved to less risky ones), weighting of assets during the accumulation phase, use of internal or external funds, and the use of active or passive strategies.

<sup>177</sup> For example, the OECD assessed the relative performance of different investment strategies, in particular looking at whether the specific glide-path of life-investment strategies and the introduction of dynamic features significantly affected retirement income. The OECD found that there is no 'one-size-fits-all' default investment option. Life-cycle and dynamic investment strategies delivered comparable returns, adjusted by risks. The length of the contribution period also affected the ranking of the different investment strategies with life-cycle strategies having a stronger positive impact the shorter the contribution period is.

OECD Assessing default investment strategies in defined contribution pension plans, 2010. Available here: [www.oecd.org/dataoecd/22/63/45390367.pdf](http://www.oecd.org/dataoecd/22/63/45390367.pdf)

See also Pensions Institute, Caveat Venditor, 2012 which finds that there is much wider distribution of outcomes in some default funds than others, due to differences in asset allocations (some funds take on greater risk) and higher charges. Available here: [www.pensions-institute.org/reports/CaveatVenditor.pdf](http://www.pensions-institute.org/reports/CaveatVenditor.pdf)

<sup>178</sup> See Chapter 8 for more detail.

higher quality, and greater value for money to members are not considered for the default options. As a result, many pension schemes are being set up with passive investment strategies with lower charges.

## Quality of governance

7.18 All pension providers, advisers, and industry experts that we consulted through the course of the study told us that good governance is crucial to achieving good member outcomes. Ongoing governance provided by the employer, trustees and provider is important for several reasons:

- A pension is a long term investment so the investment strategy has to be suitable for employees over the long term. The performance of financial markets, the cost of pension provision and investment philosophies can all evolve significantly over time, so it is important that costs and quality are kept under review.<sup>179</sup>
- There are significant potential conflicts of interests which are inherent in some providers' business models. These need to be identified and managed effectively in the interests of members.
- There is likely to be lack of oversight and scrutiny of schemes from most scheme members and many employers, so effective governance arrangements, particularly around the default option, at trustee and provider level are crucial for ensuring that the scheme continues to offer value for money.<sup>180</sup>

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

---

<sup>179</sup> This can be seen by the changes in the default fund design over the last few decades from the 'equities only' approaches of late 1990's to the most recently used target date funds (see Pensions Institute, Caveat Venditor, 2012. Available here [www.pensions-institute.org/reports/CaveatVenditor.pdf](http://www.pensions-institute.org/reports/CaveatVenditor.pdf). For a review of developments in default option design since late 1980's (pp.27-28). Also, as seen in Chapter 6, the cost of pension provision, mainly the AMC, have changed over time due to technological advances.

<sup>180</sup> DWP, Guidance for offering a default option for defined contribution AE pension schemes, May 2011. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/185056/def-opt-guid.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/185056/def-opt-guid.pdf).

7.20 Based on the discussions with market participants, the OFT considers that there are four conditions for effective governance:<sup>181</sup>

- holistic scrutiny: people with governance responsibilities need to assess schemes against all key elements of value for money
- alignment of interests: an alignment of interests between members of the scheme and those with the governance responsibilities for the scheme
- competence: people with the governance responsibilities for the scheme have the necessary skills and knowledge to make competent decisions in the interests of members, and
- effective powers: people with the governance responsibilities for the scheme have the necessary powers to act in members' interest.

7.21 We have identified and assessed the effectiveness of governance in both trust based and contract based schemes below against the four criteria outlined above.

## **Trust based schemes**

7.22 Trust based pension schemes are governed by a board of trustees, each of whom will be under a fiduciary duty to act in the best interests of members.<sup>182</sup> Trustees are responsible for the proper running of the scheme, including administration, the investment of assets and payment of benefits. There are two main ways in which governance is provided in trust based schemes:

- Single employer trusts - the scheme is set up by a single employer which appoints a board of trustees who have responsibility for governance of the scheme. There is a requirement to include member nominated trustees or an independent trustee. The board of trustees will then interact with one or a number of service providers.

---

<sup>181</sup> The importance of alignment of interests between people running the scheme and members of the scheme is also emphasized in the DWP's call for evidence on quality standards in DC schemes. DWP, Quality standards in workplace defined contribution pension schemes, Call for evidence, July 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/210700/quality-standards-workplace-defined-contribution-pension-schemes.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210700/quality-standards-workplace-defined-contribution-pension-schemes.pdf)

<sup>182</sup> TPR has produced guidance for trustees on their responsibilities. Available here: [www.thepensionsregulator.gov.uk/guidance/guidance-for-trustees.aspx#s1542](http://www.thepensionsregulator.gov.uk/guidance/guidance-for-trustees.aspx#s1542)

- Master trusts - the trustee board is normally appointed by the provider and can be removed by the provider. Employers interact with the provider of the master trust.

7.23 We have considered how well governance is working in each of the two types of scheme, and have identified issues with single employer trust based schemes of different sizes and vertically integrated master trusts. Most of these concerns were shared by the industry and TPR.<sup>183</sup>

## Large single employer trust based schemes

7.24 Based on the evidence collected from trustees, providers, investment managers, and TPR, it appears that large single employer trust based schemes tend to have good scheme governance.<sup>184</sup> These schemes tend to exert ongoing pressure on service providers because they have qualified and skilled trustees on their boards that are independent of providers and have the ability to change administrator or the investment strategy when necessary.

7.25 Nevertheless, we have heard about two potential issues with large single employer trust based schemes:

- firstly, there are concerns that in hybrid schemes where the same trustee board manages both a DB and a DC scheme trustees often tend to de-prioritise reviewing the DC scheme,<sup>185</sup> and
- secondly, some investment managers suggested that closed trust based schemes, even if they are large, may also suffer from lack of oversight.

---

<sup>183</sup> TPR, Ensuring good governance and administration in work-based defined contribution pension schemes, 2013. Available here: [www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf](http://www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf). And TPR, Delivering successful AE. The Pensions Regulator's approach to the regulation of employers and schemes, February 2012. Available here:

[www.thepensionsregulator.gov.uk/docs/delivering-successful-automatic-enrolment.pdf](http://www.thepensionsregulator.gov.uk/docs/delivering-successful-automatic-enrolment.pdf)

<sup>184</sup> TPR defines 'large schemes' as having more than 1,000 members.

<sup>185</sup> TPR, Ensuring good governance and administration in work-based defined contribution pension schemes, January 2013. Available here: [www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf](http://www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf).

## Small and medium sized single employer trust based schemes

7.26 By contrast, we have significant concerns about the governance of smaller, single employer trust based schemes. Trustees in these schemes may lack the necessary expertise and may not provide governance oversight on an ongoing basis.<sup>186</sup> These issues have been identified by both TPR and the DWP.<sup>187</sup> A recent TPR review, for example, found that 52 per cent of small schemes and 38 per cent of medium schemes had not reviewed their statement of investment principles in the last three years, even though it is a legal requirement.<sup>188</sup> In comparison, 85 per cent of large schemes had done so. Also, a recent the DWP review found that the 'less knowledgeable' trustees within the smaller employers had often not formally reviewed the default option in recent years, so that the make-up of these funds was often out of line with current practices and may not have taken into account the current membership profile.<sup>189</sup>

7.27 The OFT notes that TPR has publicly stated that, while there are examples of good quality small and medium trust based schemes, some of these schemes are less likely to be able to demonstrate the presence of quality features that TPR considers crucial in delivering

---

<sup>186</sup> However, many trust based micro schemes (schemes with fewer than 12 members) are likely to be small self-administered pensions (SSAs). SSAs are special arrangements for key staff, usually directors or key employees, where every member is a trustee. Because of their unique design and use, the OFT has deemed that these schemes should not be considered as part of this market study. Moreover, TPR does not expect SSAs to be used for AE. However, the OFT notes that the lack of data on SSAs is currently making it hard for TPR to quantify the extent to which there may be problems with other types of small trust based schemes. TPR annual returns identify 36,000 active 'micro-schemes' with fewer than 12 members, but it is unclear how many of these are SSAs. Issues with lack of data have also been raised in recent press coverage. See the recent articles in the Financial Times: [www.ftadviser.com/2013/03/25/pensions/group-pensions/hmrc-unable-to-provide-number-of-ssas-in-existence-69ci2eTod67Dyi63vJSPxJ/article.html](http://www.ftadviser.com/2013/03/25/pensions/group-pensions/hmrc-unable-to-provide-number-of-ssas-in-existence-69ci2eTod67Dyi63vJSPxJ/article.html)

<sup>187</sup> TPR, Ensuring good governance and administration in work-based defined contribution pension schemes, 2013. Available here: [www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf](http://www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf). And TPR, Delivering successful AE. The Pensions Regulator's approach to the regulation of employers and schemes, February 2012. Available here: [www.thepensionsregulator.gov.uk/docs/delivering-successful-automatic-enrolment.pdf](http://www.thepensionsregulator.gov.uk/docs/delivering-successful-automatic-enrolment.pdf)  
DWP, The use of vesting rules and default options in occupational pension schemes, 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214500/rrep725.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214500/rrep725.pdf).

<sup>188</sup> It is a legal requirement to review the Statement of Investment Principles under the The Occupational Pension Schemes (Investment) Regulations 2005. GfK, TPR, Occupational pension scheme governance: Accompanying Technical Report on the 13th (seventh) scheme governance survey, 2013. Scheme sizes are defined as follows: small schemes have 12-99 members, medium schemes have 100-999 members, large schemes have 1000 or more members. See also DWP, The use of vesting rules and default options in occupational pension schemes, 2011

<sup>189</sup> DWP, The use of vesting rules and default options in occupational pension schemes, 2013. Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214500/rrep725.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214500/rrep725.pdf).

good outcomes to members. Therefore, TPR recommends that these schemes should not be used for AE.<sup>190</sup>

## Cross-cutting issues in single employer trust based schemes

7.28 An additional issue that cuts across schemes of various sizes is that often responsibilities for default investment governance are not clearly assigned to the different parties involved in running the single employer trust based scheme. A DWP survey in 2011 found that employers, trustees and intermediaries generally agreed that within trustee boards there were no formalised processes for setting out who was responsible for designing, operating, and winding up the default option. This led to tasks being allocated on an ad hoc basis.<sup>191</sup> Regulators have since attempted to go some way towards setting out responsibilities for governance. For example, the first principle in TPR and Investment Governance Group (IGG)<sup>192</sup> guidance for investment governance is to set clear roles and responsibilities.<sup>193</sup>

## Master trusts

7.29 The master trust business model can provide small schemes with the benefit of trustee governance and potentially the efficiency benefits of a large trust based scheme. However, market participants and industry experts have all expressed concerns that some of the master trusts' business models<sup>194</sup> create conflicts of interest that do not exist in the single trust model.<sup>195</sup>

---

<sup>190</sup> Note that TPR refers to schemes with between 12 and 999 members. TPR, Delivering successful AE. The Pensions Regulator's approach to the regulation of employers and schemes, February 2012. Available here: [www.thepensionsregulator.gov.uk/docs/delivering-successful-automatic-enrolment.pdf](http://www.thepensionsregulator.gov.uk/docs/delivering-successful-automatic-enrolment.pdf). See also article: [www.professionalpensions.com/professional-pensions/news/2229521/tp-r-outlaws-autoenrolment-into-small-dc-and-legacy-schemes](http://www.professionalpensions.com/professional-pensions/news/2229521/tp-r-outlaws-autoenrolment-into-small-dc-and-legacy-schemes).

<sup>191</sup> DWP, The use of vesting rules and default options in occupational pension schemes, 2013. Available here: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214500/rrep725.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214500/rrep725.pdf).

<sup>192</sup> The Investment Governance Group (IGG) is a joint industry and governance initiative, tasked with encouraging engagement with, and standards of, investment governance across various types of workplace pension schemes.

<sup>193</sup> IGG, Principles for investment governance of work-based DC pension schemes, Available here: [www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx#s7872](http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx#s7872) and see the accompanying template [www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf](http://www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf).

<sup>194</sup> Note that not all master trusts have conflicting business models. NEST, for example, outsources all investment management to several providers.

<sup>195</sup> TPR, Ensuring good governance and administration in work-based defined contribution pension schemes, 2013. Available here: [www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf](http://www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf). Pensions Institute, Caveat Venditor, 2012. Available here [www.pensions-institute.org/reports/CaveatVenditor.pdf](http://www.pensions-institute.org/reports/CaveatVenditor.pdf). Select Committee Paper.

7.30 Both TPR and some pension providers questioned whether trustees who are paid for and appointed by the provider or adviser will have sufficient ability and motivation to challenge and change the administrator or investment manager from the in-house provider where they are underperforming. Further, in some cases there may be restrictions in the trust deeds that prevent them from doing so. In response, master trusts have told us that these conflicts of interest are managed properly and referred to trustee legal fiduciary duties. They also note the presence of independent trustees (who are still appointed and can be removed by the in-house provider) on their boards, which, in their view, provide sufficient protection to members.

7.31 The OFT is concerned that those operating on the demand side (employers and employees) will often be unable to identify these conflicts of interest and assess whether or not they are managed effectively.

7.32 In response to this risk, TPR plans to develop, in conjunction with the industry and the audit profession, a voluntary independent assurance framework which addresses these challenges. TPR has told the OFT that it is developing this assurance framework, taking into account other accreditation arrangements, such as those of the PASA, the NAPF, and the Institute of Chartered Accountants of England and Wales.

## **Contract based schemes**

7.33 Contract based DC pension products may offer the benefit of having greater economies of scale at the provider level that some trust based schemes do not have. However, in contrast to trust based schemes they do not have a recognised equivalent of the trustee board that is ultimately accountable for representing the needs of scheme members. Trustees, master trusts, experts, and even some contract based providers themselves expressed concerns about the lack of member-focused governance arrangements in contract based schemes. These concerns have also been raised by the Pensions Institute and the



House of Commons Work and Pensions Select Committee in their recent publications.<sup>196</sup>

7.34 Without strong scheme governance, conflicts of interest facing some contract providers (for example, where they are vertically integrated, see section below) may not be managed in members' interests and providers may not have the incentive and ability to address high charges, poor administration, poor performance and outdated or unsuitable investment strategies.

7.35 These risks might be mitigated in some larger schemes, where there is some oversight and scrutiny of scheme performance from employers in the form of governance committees (see Chapter 5). However, the risk of a 'governance gap' is likely to be greater in the SME sector and is likely to increase as more SMEs enter the sector during the AE period. Many of these employers are unlikely to have the resources to set up their own independent governance panels or to fund ongoing adviser scrutiny.

## **Conflicts of interest in default fund design**

7.36 A number of market participants, particularly non-integrated investment managers, are concerned that where the provider and the investment manager are vertically integrated, providers could favour the use of internal funds over external funds when designing the default investment strategy. Use of non-competitive internal funds in the design of the default option would be a particular concern if it were occurring as most members will end up investing in these funds. Nine out of ten of the largest providers of bundled trust and workplace contract based pensions that responded to our request for information are vertically integrated with in house investment managers and offer their own funds to pension savers.

7.37 The OFT analysed the data received from the vertically integrated providers on their use of internal and external funds. The use of internal funds across the providers the OFT collected data from varied

---

<sup>196</sup> Pensions Institute, Caveat Venditor, 2012. Available here, [www.pensions-institute.org/reports/CaveatVenditor.pdf](http://www.pensions-institute.org/reports/CaveatVenditor.pdf). House of Commons Work and Pensions Committee Improving governance and best practice in work place pensions, Sixth Report of Session 2012-13, available here: [www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/768/768.pdf](http://www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/768/768.pdf)

greatly (from 12 per cent to 80 per cent invested in internal funds).<sup>197</sup> For five out of six providers who submitted data by scheme size, smaller schemes were more likely to use internal assets than external assets compared to the larger schemes.<sup>198 199</sup>

7.38 Providers have told us that internal funds can offer several advantages over external funds. They have said that there are likely to be cost benefits where internalisation of funds allows some costs to be stripped out, and that providers may have greater oversight and control over internal investment manager decisions.<sup>200</sup>

7.39 The OFT is nevertheless concerned that when SME employers enter the market they will not place sufficient pressure on providers to select the best value default funds, including the 'off-the-shelf' defaults that are likely to be used for AE. This may further reduce the competitive pressure on vertically integrated providers to improve the design of their default offering. There is also a risk that in the absence of adviser pressure, there will also be limited pressure on providers to consider including external funds in their default options.

## **The OFT's concerns about contract based governance**

7.40 Most contract based providers told us that they have governance processes in place to review the products they offer. These processes appear to be similar across providers. They involve various regulatory and investment committees that continuously monitor the suitability of products, including their investment options and fund performance. TPR has noted that such governance processes within contract based

---

<sup>197</sup> The weighted average by assets and management for the use of internal assets was 45 per cent. Weighting by assets ensures that the average reflects that some providers have more assets and management than others.

<sup>198</sup> We received data from six large providers. The trend of smaller firms using more internal funds than larger firms was observed for schemes below the size of around 5,000 members. After this point, schemes tended to use more internal assets than schemes in the previous size category. One provider's data exhibited the opposite trend where the proportion of internal assets increased with scheme size.

<sup>199</sup> The OFT has been provided with limited data on use of internal funds in defaults. Several providers noted that they were unable to provide data on the default option because – apart from group stakeholder schemes – the term 'default options' did not exist for most schemes prior to automatic enrolment. As a result, some providers had not historically recorded this information on their administration systems, so could only provide limited data on their group stakeholder products. As a result, for some of the providers, the total AUM in the default option were only a small fraction of their overall funds under management. Some providers, however, identified that they invest 100 per cent of default option's assets in internal funds.

<sup>200</sup> Some academic research supports these claims. Clarke, Dutch sector-wide supplementary pensions: fund governance, European competition policy, and the geography of finance; Is Bigger Better? Size and Performance in Pension Plan Management, ICPM; CEM, internal fund management does better after costs, how large pension funds organise themselves; Fair Pensions, Whose duty? Ensuring effective stewardship in contract based pensions, 2012

schemes can give a good level of protection of investments for scheme members 'if done properly and in a compliant fashion.'<sup>201</sup>

7.41 Moreover, providers emphasised that even though they do not have a fiduciary duty to act in members' best interests, they are still required to treat customers fairly under the FCA TCF principles. Under TCF, providers claim they have to consistently demonstrate to the FCA that their product is suitable to consumers and therefore they review their products frequently. Under those principles, providers claim that members are put 'at the centre of product design', and 'annual product reviews' are undertaken to assess whether the product is still suitable.

7.42 Nevertheless, the OFT does have concerns about the governance of contract based schemes. The first concern is the lack of independent scrutiny over the key elements of value for money, particularly given the vertical integration of most providers which has the potential to give rise to scenarios where there is a conflict between what is good for the member and what will maximise returns for the provider.

7.43 To the extent that providers do review fund performance, charges and the quality of administration, the people that conduct these review are accountable to the providers' board (and ultimately shareholders) and, in contrast to trust based schemes, do not have a fiduciary duty to scheme members. As noted in Chapter 6, governance scrutiny has not resulted in action to address charges in instances where they may not represent the best value for money. Further, providers may not be incentivised to challenge the quality of internal administration and, to the extent that the provider is vertically integrated, they may not remove underperforming or high charging internal funds from the providers' platform. The OFT is concerned therefore that the lack of independent governance and scrutiny over the key elements of value for money may result in poor value for members.

7.44 The OFT's second concern is about the inflexibility of contracts which may not allow providers to update investment strategies even when it is in the members' interest to do so. Providers noted that they are

---

<sup>201</sup> TPR, Principles and features for good quality pension schemes, January 2013. Available here: [www.thepensionsregulator.gov.uk/docs/principles-and-features-for-good-quality-pension-schemes.pdf](http://www.thepensionsregulator.gov.uk/docs/principles-and-features-for-good-quality-pension-schemes.pdf)

constrained by the terms of their contracts and unable to make changes to investment strategies without the consent of all members.<sup>202</sup> Making such changes could be in members' interests due to changes in the world economy, investment innovation, charges, and other factors.<sup>203</sup>

7.45 In the future, 'white-labelled' and 'blended' defaults may offer a solution, as they permit changes to the investment strategies without necessarily having full member consent.<sup>204</sup> However, these new types of funds tend to have higher charges than direct investments in funds and are a new innovation from which very few members currently benefit. Providers also told us that they are looking for other ways in which to build in more flexibility, for example, by outlining scenarios under which the investment strategy could be changed. Greater flexibility, combined with stronger independent governance of the scheme, could therefore bring benefits to members.

## Current governance initiatives

7.46 The industry, government and regulators have recently developed several initiatives aimed at improving governance standards across the market:<sup>205</sup>

- The DWP has developed high level guidance for governance around the default option.<sup>206</sup> They have also launched a call for evidence on

---

<sup>202</sup> We have been told that contracts usually specify the investment options open to a member, and the make-up of the default option should the member not make a choice. Any change in the investment strategy or funds which constitute a switch would require members' consent, which is extremely hard to obtain due to the potentially large number of members and disengagement amongst members. A change can be made for new joiners, maybe even future contributions in some scenarios, but not for members' accumulated fund holdings. Even if providers did not consider themselves contractually constrained, they would be concerned about making changes to a default fund in case it has a negative impact on some members. They argue that by its nature a single default is unlikely to offer a perfect fit for all members, so the changes made could put some members at a disadvantage. Therefore in the absence of consent, a unilateral change could result in complaints against the provider if the member would have been better off in the previous default fund.

<sup>203</sup> Example from providers: Some scheme defaults used a single fund, investing in a limited asset class – whereas many investment experts would recommend a diversification of asset classes today.

<sup>204</sup> White-labelling allows the supply of a product on an unbranded basis to which another company adds its brand and customer interface, for example, the adviser's or employer's name. Blended funds have a 'fund-of-funds' like structure, where the fund can invest in a single or several layers of underlying funds. Both white-labelling and blending of funds can give parties, for example, trustees, advisers and providers, additional flexibility by allowing them to make changes to the underlying funds without changing scheme literature, getting explicit member consent, etc. See, for example, Standard Life "Blended funds: A guide for consultants and advisers"

<sup>205</sup> These do not include the recent IMA and ABI initiatives that aim to improve the disclosure and transparency of costs and charges which are covered in the Chapter 6. In addition, some providers in the market have taken steps to embed stronger governance frameworks within their firms. Legal & General has set up an internal governance committee to shadow the governance arrangements in trust based schemes. See article: [www.pensionsweek.com/Law-Regulation/Aviva-plans-GPP-committee-to-boost-governance](http://www.pensionsweek.com/Law-Regulation/Aviva-plans-GPP-committee-to-boost-governance)

quality standards for pension schemes and aim to develop a set of minimum legislative standards.<sup>207</sup>

- TPR has published a code of practice and regulatory guidance for trust based schemes that focuses on administration and governance.<sup>208</sup> The Investment Governance Group set up at the behest of HM Treasury, has also published guidance on investment governance.<sup>209</sup> TPR is currently working on a voluntary disclosure code and a voluntary independent assurance regime for master trusts.
- TPR and the FCA's predecessor, the FSA, have published an analysis of the extent to which TPR's DC quality features, including those in relation to governance responsibilities, map to the FSA's rules and have concluded that the rules are to a large extent aligned.<sup>210</sup> The FCA has set out their expectations that providers of work based personal pension products are responsible for ensuring that a product continues to meet the needs of its target market.<sup>211</sup> The FCA is also undertaking broader work focused on governance of investment management concentrating on conflicts of interest and unit-linked funds.<sup>212</sup>
- The Investment Management Association in conjunction with other industry bodies and regulators is currently developing a self certification statement to be completed by the scheme's trustees or by the provider of a contract based scheme. This statement

---

<sup>206</sup> DWP, Guidance for offering a default option for defined contribution AE pension schemes, May 2011.

Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/185056/def-opt-guid.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/185056/def-opt-guid.pdf)

<sup>207</sup> DWP, Quality standards in workplace defined contribution pension schemes, Call for evidence, July 2013.

Available here: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/210700/quality-standards-workplace-defined-contribution-pension-schemes.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210700/quality-standards-workplace-defined-contribution-pension-schemes.pdf)

<sup>208</sup> See TPR, Code of Practice 13: Governance and administration of occupational defined contribution trust based pension schemes. Available here: [www.thepensionsregulator.gov.uk/docs/draft-code-13-governance-administration-dc.pdf](http://www.thepensionsregulator.gov.uk/docs/draft-code-13-governance-administration-dc.pdf) and TPR, Ensuring good governance and administration in work-based defined contribution pension schemes, 2013. Available here: [www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf](http://www.thepensionsregulator.gov.uk/docs/regulating-dc-pension-schemes-regulatory-approach-consultation.pdf)

<sup>209</sup> IGG, Principles for investment governance of work-based DC pension schemes, Available here: [www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx#s7872](http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx#s7872) and see the accompanying template [www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf](http://www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf)

<sup>210</sup> FSA/TPR, Principles and features for good quality pension schemes, January 2013. Available here: [www.thepensionsregulator.gov.uk/docs/principles-and-features-for-good-quality-pension-schemes.pdf](http://www.thepensionsregulator.gov.uk/docs/principles-and-features-for-good-quality-pension-schemes.pdf)

<sup>211</sup> FSA, Pension reform – Conduct of business changes, 2011. Available here: [www.fsa.gov.uk/pubs/policy/ps11\\_08.pdf](http://www.fsa.gov.uk/pubs/policy/ps11_08.pdf).

<sup>212</sup> FSA, Conflicts of interest between asset managers and their customers: identifying and mitigating the risks, 2012. Available at: [www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf](http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf). Unit linked funds, see article: [www.fca.org.uk/news/speeches/100-days-of-the-fca](http://www.fca.org.uk/news/speeches/100-days-of-the-fca)

confirms that the default option of the scheme meets certain minimum governance standards.<sup>213</sup>

- The European Commission has recently announced that it aims to publish governance proposals for occupational pension funds this autumn.<sup>214</sup>

## Conclusion

7.47 On the basis of the evidence collected during the market study we have concerns that lack of capability and incentive misalignment on the buyer side of the market, and the difficulty for many employers and employees in assessing and comparing quality, make it very difficult to generate competition on administration, the design and execution of the investment strategy and quality of scheme governance.

7.48 Well resourced employers may be able to overcome these difficulties by putting in place good scheme governance. On the whole, governance appears to be working well for many large trust based schemes or where employers have put together internal governance panels. However, we are concerned that governance gaps have developed in the market that increase the risk that many smaller scheme members will not get value for money from their pensions in the long term.

7.49 The governance that many providers have put in place on the contract side of the market is often not sufficiently independent and does not always appear to take into account all the key elements of value for money. We anticipate that AE may see a growth in the number of employers in the market who do not have the resources to ensure that their employees will be protected by the ongoing scrutiny sometimes provided in larger firms by governance panels or the use of advisers.

7.50 We are also concerned by a potential governance failure in many small trustee based schemes. We are concerned that in many of these

---

<sup>213</sup> Such as whether the responsibilities for development, implementation and review of the default strategy are clearly delineated and documented, communications to members, taking account of member objectives, managing risk and review of the default option.

<sup>214</sup> Europa, Occupational Pension Funds (IORP): Next steps press release:  
[http://europa.eu/rapid/press-release MEMO-13-454\\_en.htm#PR\\_metaPressRelease\\_bottom](http://europa.eu/rapid/press-release_MEMO-13-454_en.htm#PR_metaPressRelease_bottom)

schemes trustees may not be regularly scrutinising value for money and that in many cases trustees may not have the necessary expertise.

7.51 Finally, we also have concerns about whether some of the master trusts that have been set up by insurance companies and advisers in recent years provide genuinely independent governance to ensure that scheme members obtain the best value for money. In reality some of these trusts are unlikely to change the administrator or fund manager, other than to those of the insurance company, even where a change to a third party fund manager and/or administrator would be in the best interests of members.

7.52 In response to our concerns about contract governance, the OFT and the DWP, the ABI and its members have agreed the introduction of Independent Governance Committees which will be embedded within all providers of contract based pensions and bundled trust based schemes. We also recommend 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.

7.53 In response to our concerns about small trust schemes, we are recommending that TPR, which is responsible for regulating these schemes, should set out how trustees can assess the key elements of value for money of their schemes, require each trust based scheme to report data to TPR on the results of their value for money assessment, with TPR to consider publishing the overall results of the exercise, and TPR then use these results to make a risk-based assessment of which schemes are at greatest risk in order to enable any further regulatory activity to be well targeted.

## **8 THE CHANGING STRUCTURE AND DYNAMICS OF THE UK WORKPLACE PENSIONS MARKET**

### **Introduction**

8.1 The DC workplace pensions market is currently going through a period of significant change. The prospect of millions of new savers entering the market as a result of AE and the effect the RDR will have on the way in which financial advisers are paid may fundamentally affect the dimensions of competition in both the short and the long term.

8.2 The OFT has identified a number of risks associated with the way in which the market might develop which may have the potential to lead to detriment for some savers. This chapter explores this potential detriment by considering how AE and the RDR may affect:

- the way in which providers and advisers are competing with each other in the short term to win business during the AE implementation phase, and
- the way that competition in the market may develop in the longer run - once the majority of employers have selected their company pension scheme.

### **Risks arising from the way in which providers and advisers compete in the short term**

8.3 Providers and advisers are currently changing the way in which they compete in the market in response to AE and the changes brought about by the RDR. The OFT has been told that AE is 'a game changer' for the industry as it offers a unique opportunity for pension providers to win new business and increase AUM. As a result, providers have an incentive to compete aggressively now, and engage in a range of sales and marketing activities to attract business from employers. At the same time, the OFT has also been told the changes arising from the RDR may result in a growing body of employers that are reluctant to



pay for advice and advisers trying to find new income streams to replace the commissions they historically received from providers.<sup>215</sup>

8.4 As a result of these developments, we have identified three risks that might arise in the market:

- employers' priorities for AE result in providers not competing on all elements of value for money
- employers choosing a pension scheme without the help of an adviser, and
- employers not recognising conflicts of interest as advisers supply services on which they also advise.

### **Employers' priorities for AE may result in providers not competing on all elements of value for money**

8.5 As described at Chapter 5, the evidence that the OFT has collected suggests that a significant proportion of employers setting up a new pension scheme for AE will be concerned to comply with the regulatory requirements brought about by AE, to find a simple way to administer their pension scheme and to minimise the costs to both employers and employees of running and investing into a pension scheme.

8.6 While it is understandable that employers choose a provider that can help them administer their pension scheme, if employers choose their pension provider primarily on the basis of ease of administration this may mean that the value for money the scheme provides to employees - including the charging structure or quality of the underlying investment strategy - is a secondary consideration. As described in Chapter 5, there may not be any countervailing pressure from employees to ensure all elements of value for money are taken into account when the employer chooses an AE provider.

8.7 It already appears that providers are starting to respond to employers' concerns by developing ways to integrate providers' IT systems with

---

<sup>215</sup> In its July 2013 report TPR highlighted the continued resistance among employers to paying specific fees for AE advice. It was noted, for example, that across all sizes of employers from large to micro, at least 50 per cent of employers indicated that they would be unwilling to pay additional fees (beyond any they may already pay) for assistance with AE. TPR, AE Commentary and Analysis, July 2013, page 32. See also Intermediaries' awareness understanding and activity in relation to workplace pension reforms, Autumn 2012, page 47

employers' HR and payroll systems. These systems are intended to enable employers to identify eligible employees, calculate their contributions, manage opt outs and handle regulatory reporting and member communication. This is to be welcomed. However in the short term at least, this may mean that providers are not as focused on competing to achieve for good member outcomes, for example, an appropriate investment strategy.

- 8.8 Feedback from providers and intermediaries suggests that, in addition to competing on the quality of administration, providers are competing on the level of the AMC. The AMC is more readily identifiable and quantifiable by employers (rather than other aspects such as whether an investment strategy matches employees' risk profiles) which may explain why it has become the focus of competition. Further, providers and other market participants have also told us that the entry of new low-cost scheme providers, such as NEST, NOW:Pensions and the Peoples' Pension, has also increased the focus on the level of AMC. A number of respondents indicated, for example, that an AMC of 0.5 per cent is now considered a competitive benchmark within the market.
- 8.9 The OFT is encouraged by the competitive pressure on charges paid by savers in the DC workplace pension market. However, the OFT has also been told that it may not be profitable for some providers to maintain low charges once SMEs reach their staging date. Employees working for SMEs are likely to be less profitable from a provider's perspective if they have fewer AUM, lower income (and therefore lower contributions into the pension pot) and are more likely to switch employer and stop contributing to the scheme before the provider breaks even.<sup>216</sup> As a result, some providers might raise charges or stop competing for AE business once the more profitable employers have chosen their providers. If so, NEST and its low cost competitors will become increasingly important in ensuring there is ongoing competition when SMEs enter the market.

---

<sup>216</sup> As noted in Chapter 6, providers base the calculation of AMCs on the predicted profitability of the scheme in order to recover its costs profitably. They are able to charge lower AMC to schemes with larger expected AUM, for example where employees make larger contributions, as the revenue from these schemes will be greater.

## **Employers may choose a pension scheme without the help of an adviser**

8.10 As highlighted in Chapter 5, advisers can play an important role in helping employers and trustees to assess the value for money of a provider's pension scheme. They can do this by strengthening the employers' bargaining position in the initial tendering process, monitoring the performance of the scheme and potentially by negotiating more competitive terms on behalf of employees. Further, in the past, employers were encouraged to use advisers as few providers were prepared to sell pension schemes direct to employers because of the costs associated with direct marketing and spending time dealing with each employer directly.

8.11 However, it appears that in the future employers are less likely to use advisers to help them set up and review their workplace pension scheme. The ban on providers paying advisers commission introduced under the RDR<sup>217</sup> means that employers now have to pay for any advice they obtain from advisers about their pensions schemes. Evidence suggests that upwards of 50 per cent of employers may be reluctant to pay any additional fees for assistance with AE.<sup>218</sup>

8.12 Some providers already appear to be responding to the potential reluctance of some employers to access advice by developing products that can be sold directly to employers rather than through intermediaries. A number of the new low-cost providers have entered the market with a simplified product proposition, which has enabled them to adopt a direct to market approach. Increasingly, this model is also being considered by pension providers as a way of accessing the large number of SMEs who are unlikely to be willing to pay an adviser to help them to identify and select a scheme for their employees. Such an approach may allow providers to grow capacity and maintain low charges to new customers through AE.

8.13 Faced with the cost of advice and availability of self-service products, there is a risk that employers go direct to one provider without shopping around for the best value for money scheme for their

---

<sup>217</sup> As well as the subsequent ban on consultancy charging

<sup>218</sup> Op. cit. TPR, AE, Commentary and Analysis, July 2013, page 32.

employees. Further, it is also possible that if an employer has selected a scheme on a self-service basis, without forming a relationship with an adviser, the employer is unlikely either to be encouraged to revisit the decision or pay an adviser to review the scheme's performance. The OFT therefore has developed remedies to help employers be able to assess the value for money of a pension product should they choose to set up and review their pension scheme without the help of advisers.<sup>219</sup>

## **Employers may not recognise conflicts of interest as advisers supply additional services in the sector**

8.14 Although advisers do play an important role in the DC workplace pensions market, the employers that do pay advisers to help them set up schemes for AE, particularly those that do not have experience in the market, may not recognise that some advisers have conflicting interests. During the course of the OFT's market study a number of providers and advisers raised concerns about the ways in which some advisers are adapting their business models in an effort to secure a future income stream now they cannot be paid new commissions from providers. The OFT has been told, for example, that advisers are increasingly providing services such as scheme administration and investment management.

8.15 Such developments could, potentially, lead to conflicts of interest if intermediaries were recommending the use of their own products or services. We note that advice to businesses is not FCA regulated.

8.16 Many of the advisers we spoke to said that they would disclose potential conflicts of interest to employers and that employers would 'see through' attempts by advisers to sell their own products or services. However, it was recognised that employers may not choose the best value for money scheme for their employees if these potential conflicts are not properly disclosed and managed. As advice to employers is not currently regulated it is possible that, as a result,

---

<sup>219</sup> In order to address our concerns about the difficulties that employers face in assessing and comparing scheme value for money, we are suggesting that the DWP consider mandating that information about charges and the key elements of scheme quality should be provided to employers in a comparable format (please see Chapter 9 for more detail).

conflicts of interest are not properly managed in the corporate advice market.

8.17 There is also a risk that some employers will not be able to assess the value for money of some advisory services, such as blended funds,<sup>220</sup> which add extra cost to the consultants' fee and may result in members paying a higher AMC.<sup>221</sup> The process of blending funds essentially creates an investment strategy that is tailored to scheme members' needs and is in contrast to, for example, a default investment strategy which offers a more standardised approach. Advisers who offer the option to blend funds can gain fee income from normal consultancy, through employer trustee advice, and an additional investment consultancy fee for blending the funds.<sup>222</sup>

8.18 The OFT has not identified specific evidence of harm arising from the increase in conflicts of interest as advisers provide additional services on which they also advise. However, it would be concerned if evidence emerged that suggested advisers were recommending their own products whilst claiming to also offer independent financial advice, that conflicts of interest were not being disclosed to employers, or complex services were being recommended for the 'mass market' of AE employees. It may therefore be appropriate for the FCA to monitor trends in the corporate advisory market and proactively consider whether conflicts of interest are adequately managed.

## **Risks arising from the way that competition may develop in the longer term**

8.19 By 2018, the vast majority of employers will have chosen a pension provider and will have automatically enrolled their employees into a workplace pension scheme. Therefore, beyond 2018, the opportunities for providers to win 'new' DC business will be limited and the market is likely to revert to a situation where, to the extent that it takes place, competition is focused on winning 'existing' business from rivals.

---

<sup>220</sup> A blended fund involves an intermediary creating a bespoke fund from a range of other funds which may be on offer from pension providers or investment managers.

<sup>221</sup> [www.pensions-insight.co.uk/aviva-weighs-in-on-charges/1471990.article](http://www.pensions-insight.co.uk/aviva-weighs-in-on-charges/1471990.article)

<sup>222</sup> [www.moneymarketing.co.uk/channels/corporate-adviser/investment/the-right-blend/1041100.article](http://www.moneymarketing.co.uk/channels/corporate-adviser/investment/the-right-blend/1041100.article)

8.20 In the following sections we consider some of the potential risks that might arise as the market reverts to a new 'steady state' including:

- the anticipated rate of switching being insufficient to maintain ongoing competitive pressure, and
- members of schemes that are 'won' by providers that fail to achieve efficient scale may receive poor value for money or experience other forms of potential consumer detriment if the provider exits the market.

### **Anticipated rates of switching may be insufficient to maintain ongoing competitive pressure**

8.21 The DC pensions market is characterised by a high degree of buyer inertia which is likely to continue in the future as SMEs enter the market. Larger and more paternalistic employers who have traditionally been prepared to review schemes and pay for advice are likely to continue to do so. However, it is less likely that other employers who have set up pension schemes due to the requirement of AE will review and monitor their pension scheme on an ongoing basis.

8.22 The OFT has been told that the changes arising from the RDR will reduce the level of switching between pension providers further below levels of switching outlined in Chapter 4. One of the reasons why the RDR was implemented was to overcome conflicts of interest when advisers were remunerated by commission from the product provider which, in some cases, may have driven unnecessary switching in the market.<sup>223</sup> However, based on the feedback provided to the OFT from providers and intermediaries, in future the incentive for advisers to trigger a review of schemes' value for money could effectively disappear in some segments of the market. This is because employers may not be willing to pay for the help of advisers, or advisers may not be willing to recommend switching away from schemes from which they are receiving ongoing trail commission.<sup>224</sup> Indeed, the OFT has been told that a significant amount of AE business was written ahead of the RDR deadline for banning commission so that advisers could continue to receive commission after 2013.

---

<sup>223</sup> This created the risk that switching was motivated in part by the adviser's desire to secure a higher revenue stream from commission from the pension provider rather than acting in the best interests of the employee and employer.

<sup>224</sup> If employers switch to a new scheme it would cut off the commission advisers receive from that scheme.

8.23 Ongoing buyer inertia and the lack of commission-based advisers driving switching may limit the extent to which incumbent providers will be constrained by the threat of an employer switching to a competitor.

## **Consequences of providers failing to achieve sufficient scale**

8.24 As outlined in Chapter 4 (see paragraphs 4.18-4.19), scale is important in the DC workplace pension market. By achieving scale, particularly in relation to AUM, a provider can ensure that the overhead costs of platforms, systems and processes, including the costs of governance, can be covered effectively by the revenue it generates from its charges across the population of its members. Market participants anticipate that during the AE period there will be intense competition aimed at winning sufficient business to achieve such scale.

8.25 However, a number of providers and intermediaries told the OFT that some of the newer providers that have entered the market to take advantage of the opportunities presented by AE may not achieve efficient scale during the AE period. This may be particularly likely if they do not have an existing installed base of more profitable customers to cushion them from any early losses related to new AE business before the assets in those schemes grow.

8.26 The risk that new providers do not reach the necessary efficient scale is a particular concern in the DC workplace pension market as barriers to entry, at least in some sections of the market, are relatively low. Large insurance firms that provide contract based schemes are subject to prudential regulation by the PRA and are required to maintain capital liquidity to deal with operational risks. In contrast, there is a lack of prudential or capital requirements on trust based schemes, including master trusts. A significant number of the industry participants that we spoke to expressed concern that, as a result, entry into the master trust segment of the market may result in a number of master trusts that do not achieve efficient scale. Employers choosing an off-the-shelf pension scheme may also not appreciate the different levels prudential regulation that applies to master trust products compared to contract based products.

8.27 One possible outcome if a provider fails to achieve an efficient scale is that they remain in the market but cut quality or increase charges to remain viable. In other markets, where the buyers are well informed and engaged, a reduction in quality or increase in charges may be likely to trigger switching. However, there appears to be a significant risk that some employers that have automatically enrolled their employees will not be aware of this risk and/or may not be prepared to pay an adviser to review the quality and performance of the scheme on an ongoing basis.

8.28 Alternatively, while some providers who do not achieve the scale of business anticipated may remain in the market, others may choose, or be forced, to exit. This would not necessarily pose a risk to scheme members if it is undertaken in an orderly fashion with the scheme being taken on by another provider.<sup>225</sup> However, if alternative providers are reluctant to take on a scheme because its financial position is weak as a result of its unsustainable pricing structures, or if scheme assets were not protected, or if members incur penalties when transferring to another provider, it could potentially disrupt the market, expose some scheme members to harm and undermine trust in the DC workplace pensions sector. There is some limited precedent for the withdrawal of providers from the DC market, but there is no precedent for the failure of a provider.<sup>226</sup>

8.29 In terms of whether scheme member assets would be protected if a provider failed, the rules are very clear and well tested for DB schemes, with members' funds being protected by the Pension Protection Fund.<sup>227</sup> However, they are less clear in relation to DC schemes.

8.30 The OFT has been told that funds invested in products provided by insurance companies and investment managers are covered by FCA/PRA capital requirements and the FSCS. In addition, the OFT understands that the underlying investment funds used by trust based schemes, including master trusts, would also be protected by the

---

<sup>225</sup> There may, however, be costs for members. These could include, for example, out-of-market risks, bid-offer spreads as well as legal, audit and regulatory costs.

<sup>226</sup> For example when Threadneedle withdrew from the DC market its business was taken over by L&G.

<sup>227</sup> Under DB, the employer is responsible for making sure there is enough money in the pension fund to pay each member the promised amount. However, should the employer become insolvent, there are protections in place to mitigate the risk to scheme members and members are compensated from the Pension Protection Fund (PPF).



FSCS if the funds used were registered with the FCA. However, there are rules which restrict who can make claims of the FSCS - larger employers, for example, may not be able to make a claim.<sup>228</sup>

8.31 Such differences are unlikely to be apparent to employers selecting between, for example, a mass market contract based scheme and a master trust scheme.

8.32 TPR is aware of the risk that some member assets may not be protected in the event of the failure of a provider. In its recent guidance to employers,<sup>229</sup> for example, TPR recommends that employers and their advisers should ask providers to confirm that the investment options offered to scheme members qualify for protection and compensation arrangements, for example under the FSCS. It also urges employers, advisers and providers to explain the compensation available to members in their particular scheme and to set out the situations the compensation will cover if things go wrong. They also suggest that the employer should check that the provider is required to hold enough money in reserve to ensure that they are able to survive as a business even if they encounter severe problems.

8.33 Nevertheless, the OFT is of the view that more could be done to ensure members are afforded similar levels of protection regardless of the type of scheme into which they are automatically enrolled. To address our concern that some newer schemes are being designed in expectation of a level of scale they may not achieve, we recommend that master trust schemes should demonstrate to TPR that they can deliver ongoing value for money for members on the basis of realistic growth plans and contingencies.

8.34 Further, to address the significant risk that employers choosing an off-the-shelf pension will not appreciate the different levels of consumer and financial protection that apply to master trust products compared to contract based products, we recommend that government and

---

<sup>228</sup> The FSCS was set up mainly to assist private individuals, although smaller businesses and smaller charities are also covered. Larger businesses and larger charities are generally excluded, although there are some exceptions to this for deposit and insurance claims. See [www.fscs.org.uk/what-we-cover/eligibility-rules](http://www.fscs.org.uk/what-we-cover/eligibility-rules).

<sup>229</sup> TPR: A quick guide to selecting a good quality pension scheme for AE. Information for employers. July 2013, page 6.

regulators should aim to ensure a similarly high level of protection for master trust schemes.

## Conclusion

8.35 As set out in the earlier chapters, competition in the DC workplace pensions market cannot be relied upon alone to generate good value for money outcomes for many pension scheme members.

8.36 The major developments that the sector is due to go through as a result of both AE and the RDR are unlikely to change these fundamental weaknesses in the way that the market functions. There is however a risk that they might exacerbate the potential for detriment to consumers.

8.37 In terms of initially selecting a scheme:

- perhaps understandably, many of the employers entering the market for the first time as a result of AE seem to be focused more on finding a product that will enable them to fulfil their regulatory obligations under AE, rather than primarily focusing on the key elements of a value for money scheme for their employees, and
- it also seems possible that many of these employers will not use an adviser to help them select a scheme, either because they are reluctant to pay for this service, or because capacity constraints in the market make it difficult to find a suitable adviser.

8.38 Further, once AE is completed we are concerned that:

- post- RDR, the rate of switching between certain schemes will be very low without advisers having the incentive to instigate switching to generate new revenue streams, and
- some employees will have been enrolled into schemes with providers that are not successful in achieving an efficient scale - with the potential to lead to further consumer detriment.

8.39 The OFT has developed a set of recommendations aimed at addressing these risks. Our key focus has been on making information about charges and scheme quality more easily comparable to help employers that do not pay for advice be able to assess value for money, improving the quality of governance to ensure all elements of value for money are kept at a high standard and ensuring similar levels of financial and consumer protection across all types of scheme in the market.

## **9 RECOMMENDATIONS AND PROVISIONAL DECISION NOT TO MAKE A MARKET INVESTIGATION REFERENCE**

9.1 This chapter sets out the package of recommendations and actions which the OFT considers should be implemented to address the problems identified in the DC workplace pensions market. This chapter also sets out the OFT's provisional decision not to make MIR.

### **Recommendations**

9.2 As set out in the earlier chapters, the OFT has concerns over the functioning of the DC workplace pensions market. In particular, the OFT believes that the combination of a complex product and weaknesses in the buyer side of the market means that competition cannot be relied upon to drive value for money for all scheme members.

9.3 On 11 July 2013, the OFT published a progress update<sup>230</sup> which set out how these concerns had led to certain parts of the market apparently not operating in scheme members' best interests. These included:

- The current level of governance over the performance of some schemes may not be sufficient to ensure that scheme members are getting the best possible investment outcomes.
- A number of schemes have been set up with two-tier charging structures, where those members who have stopped making contributions pay a higher AMC percentage.
- There are a number of schemes open for AE that appear to have built-in adviser commissions and which may not represent the best value for money for those that could be enrolled into them,

---

<sup>230</sup> [www.oft.gov.uk/OFTwork/markets-work/pensions/](http://www.oft.gov.uk/OFTwork/markets-work/pensions/)

- There may be a number of schemes that do not have a realistic prospect of reaching sufficient scale to generate value for their members.
- The way that different providers currently present their charges may mean that they are not easily comparable.
- There may be some schemes - primarily but not exclusively those sold prior to 2001 - that have charges that may not represent value for money, or that may not reflect current standards of scheme design.

9.4 After publication of the progress report, the OFT held discussions with the Government, regulators and industry on the scope and scale of our concerns and what action might be appropriate to address them. The OFT also held discussions with the panel of industry experts<sup>231</sup> it convened to help test our findings and develop our recommendations.

9.5 Following these discussions, the OFT proposes a series of recommendations aimed at addressing risks of detriment in the short and medium term. These cover:

- improving the governance of schemes in order to improve ongoing scrutiny of value for money on behalf of scheme members
- improving the quality of information available about these complex products in order to make decision making on value for money easier
- ending the current risks of consumer detriment, and
- preventing detriment to pension scheme members in the future.

9.6 The OFT is encouraged by the willingness of the Government, regulators and industry to implement the remedies and will maintain an active interest in their implementation.

---

<sup>231</sup> Please see paragraph 2.14-2.15 for more information on the panel of experts.

## **Improving governance to address buyer side weaknesses**

- 9.7 The buyer side of the DC workplace pensions market is one of the weakest that the OFT has analysed in recent years. Part of the reason for this is that most employees do not engage with, or understand, their pensions. Pensions are complicated products, the benefits of which occur a long time in the future for many people.
- 9.8 Furthermore, while the person who bears the risks and rewards of a DC workplace pension is the scheme member, they are not responsible for choosing key elements of the product. Instead, the choice of a DC workplace pension rests largely with their employer, who may not have the capability or the motivation to drive competition on the key elements of value for money in the interests of scheme members.
- 9.9 In light of our findings on the weaknesses of the buyer side of the market, we would like to see the Government introduce minimum governance standards set for all pension schemes in order to ensure a consistent degree of ongoing scrutiny and assessment of value for money into the future.
- 9.10 In particular, we have found that the governance that providers have 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.<sup>232</sup> Well resourced employers may be able to mitigate the risks this creates, by putting in place good scheme governance that can act as a substitute for any weaknesses in their own understanding of the market. However, AE will see a growth in the number of employers in the market that do not have the resources to provide ongoing governance or scrutiny of scheme value for money.
- 9.11 In light of these concerns, after discussion with the OFT and the DWP, the ABI and its members have agreed the introduction of Independent Governance Committees which will be embedded within all providers of contract based and bundled trust based schemes.<sup>233</sup>

---

<sup>232</sup> Please see paragraphs 7.41 to 7.46 for more detail.

<sup>233</sup> The ABI suggested that smaller providers may choose to employ an independent governing person or firm in place of the Independent Governance Committee. The OFT has not taken a position on this proposal.

9.12 The key elements of this agreement are:

- The Independent Governance Committees should be made up of a majority of independent members and have an independent Chair.
- The Committee will have both the expertise and the resources to carry out its duties.
- The Committee will consider all the key elements of the value for money of schemes.
- If the Committee identifies a problem with the value for money that a scheme or number of schemes offer it will report a proposed action to the pension provider's Board. The Board will have a 'comply or explain' duty to act on these recommendations. If the Board fails to act on the Committee's recommendation in a way that satisfies the Committee then it will have the power to make the matter public, to inform the employee and employer and to escalate the matter to the relevant regulator.

9.13 The implementation of these Committees will need careful consideration, given the potential for conflicts of interest with the providers' duty to shareholders, and given the information asymmetry that the Committee may face in monitoring the provider. Where there is a risk of poor value for money, it is vital that the Committees are able to take independent action backed up by the regulator where necessary.

9.14 We also recommend 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. On the trust side, including master trusts, this standard would need suitable definition and oversight to ensure that trustees are genuinely able to carry out their fiduciary duty, including by moving scheme assets to alternative fund managers and administrators where that is in the members' interest.

9.15 We consider that these governance standards will help to address a number of problems which stem from weaknesses in the buyer side of the market and complexity of the product. In particular, we would expect governance committees to be able to identify situations where scheme members are getting poor value for money either as a result of uncompetitive charges or poor quality of investment design, and implement changes to the pension product as a result. We would also expect that expert governance will overcome many of the issues of product complexity that arise in trying to assess charges and quality and create more pressure to improve these key elements of value for money.

### **Improving the quality of information available about these complex products**

9.16 The OFT considers that buyer side weakness found in the market and the complexity of the pension product combine to reduce competition on charges and quality. For instance, charges levied on scheme members can be difficult to understand and there are a wide range of different costs and charges. In addition, we have concerns that the difficulties involved in assessing and comparing scheme quality over the long term make it very difficult to generate competition on the quality of administration, investment strategy and execution across the market.

9.17 Accordingly, in order to make decision making on value for money easier, we have developed three recommendations for the Government on how transparency of pension costs, charges and quality can be improved for those schemes eligible for AE.

9.18 In order to address our concerns about the transparency and consistency of charges,<sup>234</sup> 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.<sup>235</sup>

---

<sup>234</sup> Please see paragraph 6.19 for more detail.

<sup>235</sup> Master trusts that levy other charges, in addition to an AMC, should provide employers with an equivalent comparable single figure.



9.19 The only type of costs that the OFT suggests is omitted from this single charge would be investment management transaction costs<sup>236</sup> because, in the OFT's view, their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the members' interest. However, these costs should be transparently reported and made available to Independent Governance Committees<sup>237</sup> 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. We recommend that the FCA undertake this work as part of its planned competition review of wholesale markets.

9.20 In order to address our concerns about the difficulties that employers face when assessing and comparing scheme quality,<sup>238</sup> we suggest that the DWP consider whether 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 – could 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.<sup>239</sup>

### **Ending the current risks of consumer detriment**

9.21 We believe that there are existing members of both contract and trust based schemes that are at risk of suffering consumer detriment without action by the Government, regulators and the industry.

#### **Legacy schemes**

9.22 We have identified around £30 billion of savers' money in contract and bundled trust schemes with charges at risk of being poor value for

---

<sup>236</sup> Costs that are incurred directly as a result of buying and selling fund assets.

<sup>237</sup> Please see paragraph 9.12 for more detail.

<sup>238</sup> Please see paragraph 7.16 for more detail.

<sup>239</sup> NAPF(2012) Pension Charges Made Clear: Joint Industry Code of Conduct, Telling Employers about DC pension charges [www.napf.co.uk/PolicyandResearch/Charges-code-of-conduct.aspx](http://www.napf.co.uk/PolicyandResearch/Charges-code-of-conduct.aspx)

money. In response, the ABI, and those of its members that provide contract based DC pensions, have 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.
- 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,<sup>240</sup> to ensure that these recommendations are carried out.

9.23 We have also considered whether a charge cap might be a more effective approach to addressing the potential consumer detriment arising from legacy schemes. However we concluded that the audit process above is preferable for three main reasons. First, from the evidence we have seen, some legacy schemes may offer value for money benefits such as guaranteed annuity rates. We would be concerned that a blanket approach, such as a charge cap, could result in such benefits falling away. Second, as noted above, we have found 18 different names and configurations of charges for legacy schemes. Defining a charge that captures all these configurations and setting the level of the cap on that charge would be difficult. Finally and more broadly, charge caps create a risk of unintended consequences. Set too high, a cap can become a target for providers. Set too low, a cap can create incentives for providers to lower quality and/or impose charges elsewhere.

9.24 While we would not rule out a charge cap, it should be considered in full knowledge of the different charges and benefits that apply in the

---

<sup>240</sup> Please see paragraph 9.12 for more detail.

market and of the risks that a cap might entail. We consider that the audit of scheme charges might be a helpful part of that process.

## Small trust based schemes

9.25 There are also around 2,900 small and medium size trust based schemes (with between 12-999 members) holding around £10 billion assets,<sup>241</sup> many of which appear to be at risk of delivering poor value for money due to lower standards of trustee engagement and capability. It is also possible that some of the 36,000 'micro' schemes (with between two and 11 members)<sup>242</sup> holding around £160 billion<sup>243</sup> might also be affected by similar issues – although a significant proportion of those schemes are likely to be executive-type or member-directing schemes run by their members and are therefore of less concern.

9.26 We therefore recommend that TPR, which is responsible for regulating these schemes, should:

- set out how trustees can assess the key elements of value for money of their trust based schemes<sup>244</sup>
- require each trust based scheme to report data to TPR on the results of their value for money assessment, with TPR to consider publishing the overall results of the exercise
- integrate this data with their risk framework and make an assessment of which schemes are at greatest risk in order to enable any further regulatory activity to be well targeted, and
- carry out an exercise to establish the key barriers to closing trust based schemes that offer poor value for money and transferring members' assets to alternative schemes.

---

<sup>241</sup> According to [www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

<sup>242</sup> [www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx](http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx)

<sup>243</sup> Spence Johnson estimates that there are £183 billion assets in all trust based schemes. TPR estimates that there are £24 billion assets in trust based schemes with 12 or more members. Therefore, approximately £160 billion in 'micro' schemes.

<sup>244</sup> Trustees will be better able to assess value for money once the DWP and the industry has worked on a common framework for capturing costs, charges, and investment performance in a consistent and comparable way to enable schemes to evaluate the value for money of their scheme.

9.27 In light of TPR's findings, the Government should consider whether there is the potential to put greater onus on trustees to prove their compliance with value for money standards, whether the enforcement powers currently available to TPR are sufficient and whether any barriers to closing trust based schemes should be addressed.

#### **Preventing risks of consumer detriment in the future**

9.28 We also want to ensure that those people due to be automatically enrolled into a DC workplace pension are in a position to receive value for money in the long term, by preventing some of the practices that have emerged in the market in response to competition weaknesses.

9.29 In particular, we have concerns about the practice of increasing the AMC members pay when they stop contributing to a pension scheme. These charging structures, known as AMDs, are used by a number of major pension providers. We estimate that there are currently around 10,000 contract based schemes with AMDs, containing around £13.4 billion of assets. The OFT has found that, on average, members of these schemes can expect their AMC to increase by 0.47 percentage points if they stop contributing.

9.30 We are also concerned that employees may be automatically enrolled into schemes that contain in-built adviser commissions that form part of the overall charge to members. Although setting up such schemes was banned in January 2013, it remains possible to enrol employees into such schemes if they were set up prior to this point. If employees are automatically enrolled into schemes with in-built adviser commissions, this has two potentially undesirable consequences. Firstly, the scheme member may pay the adviser from their charges without realising it. Secondly, the existence of such schemes creates a barrier to switching because an adviser would lose this commission stream if it advised the employer to switch in future, therefore disincentivising them from giving such advice.

9.31 In light of these concerns, we recommend that the Government consider introducing the following standards for schemes used for AE:

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

9.32 The OFT is also concerned that some new providers entering the market in the context of AE may not win sufficient business to achieve economies of scale and deliver value for money. In particular, we note the ease with which it has been possible to set up a master trust has allowed a significant number of new master trust providers to enter the market.

9.33 In light of these concerns, we recommend that:

- master trust schemes should demonstrate to TPR that they can deliver ongoing value for money for members on the basis of realistic growth plans and contingencies, and
- in response to our concern that there is a significant risk that employers, when choosing an off-the-shelf pension, will not appreciate the different levels of consumer and financial protection that may apply to master trust products compared to a contract based products,<sup>245</sup> Government and regulators should aim to ensure an equivalent level of protection between these two mass-market products.

---

<sup>245</sup> Please see paragraphs 8.29 to 8.33 for more detail.

## Longer term principles

9.34 We are confident that the recommendations above will address the risks of consumer detriment arising in the short to medium term in the context of AE. This is the urgent challenge to which this report is addressed.

9.35 A longer term challenge remains, however. The structure of the DC pensions market in the UK has resulted from the rapid decline of DB provision and the need to put alternative provision in its place. It has therefore been built largely on the back of structures and products designed for the provision of single firm DB workplace pensions topped up by individual private pensions. Key elements of the DC market – single firm trusts, integrated insurance providers and contract based schemes – are based in this DB tradition.

9.36 One would expect this market structure to evolve as the demand for DC workplace pensions grows. The emergence of master trusts is one example with the potential to offer scale coupled with independent governance. We also note that greater investment flexibility is being built into new contract pension products. However, one consequence of a weak demand side is that product innovations and market structures can take time to evolve.

9.37 We therefore consider it would be helpful for future policy and regulatory initiatives to be informed by longer term principles for how the DC workplace pension market should evolve. In our view, these principles would be:

- Scale: there are significant economies of scale in the purchase of administration and investment, and in the governance of pension schemes. We would expect the market to take greater advantage of these scale economies over time, but policies could help accelerate this process and remove barriers to scale while avoiding concentration.
- Alignment of incentives: better alignment of the incentives of employers, trustees, advisers, providers and investment managers with those of scheme members is the best way to ensure that

actions are taken in the interest of scheme members. This should be coupled with clear responsibility and accountability for those making choices on behalf of savers. Regulation should promote this alignment and accountability and avoid steps that might result in misalignment of incentives.

- **Robust independent governance:** DB schemes created strong incentives for employers to set up engaged expert investment governance given the risks that employers were exposed to. While some parts of the market may be able to re-create robust governance for DC schemes, there is a role for policy to promote this across the market.
- **Flexibility:** effective governance needs to be backed up by the flexibility to move assets and change administration. We would expect the DC market to develop products that allow greater flexibility in investment decisions, including products that allow for collective pooling of risk between scheme members. There is however likely to be a role for policy in providing the regulatory context for these developments.
- **Simplicity and switching:** in the interests of promoting switching ,policy should look to promote simpler products, with transparent charges. It should also look to ease the process for employees and trustees of switching between different pension products.

9.38 Our recommendations above are based on these principles and we would advocate for them to be reflected in on-going policy and regulatory developments. The OFT will maintain a keen interest in how this market develops over time.

## **Consideration of a Market Investigation Reference**

9.39 The remainder of this chapter sets out the reasons why the OFT is not minded to refer the DC workplace pensions market to the CC and invites views on this provisional decision.

## **The reference test**

9.40 In order to make a MIR, the OFT must have reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK ('the reference test').<sup>246</sup> Where the reference test is met, the OFT has discretion as to whether in fact to make a reference.

9.41 Section 131(2) of the Enterprise Act 2002 (EA02) states that a feature of the market is to be construed as a reference to:

- the structure of the market concerned or any aspect of that structure
- any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned, or
- any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

## **Exercise of the OFT's discretion**

9.42 The OFT has the discretion, rather than a duty, to make a reference in relation to a market which it believes meets the threshold set out in Section 131. The OFT's guidance on market investigation references sets out four criteria, which guide the exercise of the OFT's discretion to make a reference. These are:

- Alternative powers: it would not be more suitable to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT or, where appropriate, to sectoral regulators.
- Undertakings in lieu: it would not be more appropriate to address the problem identified by means of undertakings in lieu (UIL),

---

<sup>246</sup> Section 131 Enterprise Act 2002. See - Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act; OFT 511, March 2006.



- Appropriateness of an MIR: the scale of the suspected problem, in terms of its adverse effect on competition, is such that an MIR would be an appropriate response to it.
- Availability of remedies: there is a reasonable chance that appropriate remedies will be available (to the CC, in the event of an MIR).<sup>247</sup>

## Provisional decision not to make a market investigation reference

9.43 During the course of the market study, the OFT has identified a number of features of the DC workplace pension market that, in its view, meet the reference test:

- **Weaknesses on the buyer side of the market** - Scheme members are reliant on their employers to make most of the key decisions about their pensions for them and many employers lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term.
- **Quality of scheme governance and ongoing scrutiny of performance** - 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. In addition nearly all the major contract based providers have a vertically integrated investment management arm. While there might be strong efficiency arguments for this, given the weakness of the demand side of the market and the lack of ongoing scrutiny of value for money, the potential for conflicts of interest gives rise to concern.
- **Quality of information and the complexity of the product** - DC workplace pensions are complicated products. Both their costs and quality are difficult to observe and outcomes may not be apparent for some years. For example, charges levied on scheme members

---

<sup>247</sup> Paragraph 2.1 of the MIR Guidance.

can be difficult to understand and there are a wide range of different costs and charges. In addition, most charges are not paid directly by employers or scheme members but indirectly - usually through annual deductions from the latter's pension assets. We are also concerned that it is difficult to assess and compare pension scheme quality over the long term, making it very difficult to generate competition on the quality of administration and investment strategy and execution. This makes decision making on value for money very difficult.

9.44 However, having considered the features identified in this market study in the context of the above discretionary criteria, we are minded to conclude that despite the reference test being met, this is not a case in which the OFT should exercise its discretion to refer at this point in time. Rather, we consider that the remedies developed by the OFT (as set out above) render a MIR to the CC a disproportionate response to the competition problems identified.

9.45 The OFT's assessment against the four discretionary criteria is presented below.

### **Alternative powers**

9.46 The OFT does not consider that alternative powers could address the market features it has identified in an effective and efficient manner. In making this assessment, the OFT has considered both the competition and consumer powers available to it and the powers of other relevant bodies, such as the FCA and TPR.

9.47 First, the OFT has not received evidence that the prohibitions in Chapter I or Chapter II of the Competition Act 1998 have been breached, nor that there is behaviour which might breach Articles 101 or 102 of the Treaty on the Functioning of the European Union (TFEU).

9.48 Second, the OFT does not consider the potential use of its consumer powers to be more appropriate than the set of remedies outlined above that we consider offer a more expedient and efficient solution.

9.49 We have also considered whether the FCA, the regulator of contract based pensions, or TPR, the regulator of trust based pensions, could use their regulatory powers to address the features of the market identified. However, having discussed this possibility with both regulators, the set of remedies secured by the OFT are considered a more expedient and efficient solution to the features identified. It will be important, however, for the regulators to use their powers effectively in the delivery and/or enforcement of the recommendations set out in this report.

## **Undertakings in lieu**

9.50 Under section 154 of the EA02, the OFT has the power to accept UIL if it considers that it has the power to make an MIR under section 131 and otherwise intends to do so. In accepting UIL, the OFT must have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned, and any detrimental effects on consumers as may result from it.

9.51 The ability to accept UIL is limited to occasions when the OFT considers that all the other discretionary criteria for making a reference have been met, which is not the case in this instance as the OFT has secured a set of remedies that it believes will make a reference disproportionate.

9.52 Therefore, the OFT considers that acceptance of UIL would not be appropriate in this instance.

## **Appropriateness of an MIR**

9.53 A critical factor in assessing whether an MIR is appropriate is whether it is proportionate to the scale of the competition concerns identified. The OFT guidance on MIRs notes that an MIR will only be made when the OFT has reasonable grounds to suspect that the adverse effects on competition of features of a market are significant. The following three criteria are relevant to whether adverse effects on competition are significant, and thus whether an MIR may be appropriate:

- the size of the market
- the proportion of the market affected by the features that prevent, restrict and distort competition, and
- the persistence of the features identified as adversely affecting competition.

9.54 Overall, the OFT considers that the features it has identified are likely to have a significant detrimental effect on consumers. First in relation to the particular factors in the guidance, the OFT notes that:

- The DC workplace pensions market is large, with the value of assets invested in these schemes currently standing at £275 billion. This should at least double by 2022.
- For the contract and bundled trust side of the market, we have identified around £30 billion of scheme assets that are at risk of having charges that are too high to represent value for money.
- For the trust based side of the market, we have also identified around 2,900 trust based schemes holding around £10 billion assets where there appears to be a high risk that scheme members are not receiving value for money.

9.55 Therefore, even a relatively small reduction in any adverse effect on competition identified by the CC, would offset the costs of an MIR and would have a beneficial impact for large numbers of consumers.

9.56 Second, a significant proportion of the market is affected by the features which give rise to the OFT's competition concerns. For example, the inability of many scheme members or employees to evaluate value for money or stimulate competitive rivalry between providers in the market impacts a significant part of the pensions market - including both contract and trust AE qualifying schemes.

9.57 Third, absent intervention, the features identified as adversely affecting competition are likely to be persistent in nature. There are, however, a number of significant market developments that have the potential to impact the persistence of the features identified and,

therefore, render a MIR to the CC disproportionate at this time. For instance, the OFT has secured a commitment from the ABI and its members to embed Independent Governance Bodies into all contract based pension schemes by mid 2014. In addition, we expect DWP to include the OFT's recommendations on charges and quality standards in their forthcoming consultations. The OFT considers that these remedies will render disproportionate a MIR to the CC at this point in time.

9.58 The DWP's consultations on charges and quality standards may not immediately impact the concerns<sup>248</sup> identified for legacy and high cost contract and small trust based schemes. The OFT has, therefore, agreed the following remedies with the ABI and TPR which should have a more immediate impact on the features of the market identified and, therefore, render a MIR to the CC disproportionate at this point in time:

- the ABI and its members have committed to audit all schemes sold pre 2001 and all other schemes with charges over 1 per cent and to take remedial action where consumers are not receiving value for money, and
- TPR have committed to set out how trustees can assess the value for money of small trust based schemes. The trustees will then report the results of their assessment to TPR, who will use the results to assess which schemes are at greatest risk, and target further regulatory activity accordingly.<sup>249</sup>

## **Availability of remedies**

9.59 It is not for the OFT to determine which remedies would or would not be appropriate were a reference to be made. In the context of a decision on a MIR, the OFT is required to assess whether there is a reasonable chance that remedies would be available to the CC if it finds one or more adverse effects on competition following a detailed investigation.

---

<sup>248</sup> Please see paragraph 6.43 to 6.51 for more details.

<sup>249</sup> Please see paragraph 9.26 for more detail

9.60 In respect of this discretionary criteria, the most likely remedies available to the CC, for example recommendations to the DWP, the regulators and industry, have been made by the OFT. In addition, the recommendations made by the OFT and the forthcoming regulatory intervention by the DWP, will make it difficult for the CC to reach robust judgements about how competition is likely to evolve in the short term, and how to design appropriate, effective and proportionate remedies to any adverse effects on competition.

9.61 The CC could, arguably, enforce alternative remedies to those pursued by the OFT, such as prohibiting vertical integration of investment management or requiring increased information disclosure. However, the OFT's remedies on improving the quality of governance and the DWP's consideration of mandating the disclosure of information on scheme quality, means that such direct intervention by the CC might be unnecessary.

9.62 The OFT will, however, maintain an active interest in the implementation of its remedies to ensure they remain the most appropriate solution to the problems identified.

## **Conclusion and consultation on the OFT's provisional decision**

9.63 In view of the factors set out above, the OFT has provisionally decided that it should not exercise its discretion to make a MIR in relation to the DC workplace pensions market at the present time.

9.64 We are consulting on our provisional decision not to make a reference to the CC. Responses to the consultation must be made in writing and can be emailed to [pensions@oft.gsi.gov.uk](mailto:pensions@oft.gsi.gov.uk) by **5:00pm on 31 October 2013**.

9.65 Alternatively, they can be sent by post to:

Pensions Market Study Consultation (Floor 8C)  
Office of Fair Trading  
Fleetbank House  
2-6 Salisbury Square  
London EC4Y 8JX

9.66 We will consider any responses received and will publish our final decision on a MIR in due course.