Title: Charges in Qualifying Pension Schemes: IA	# Impact Assessment (IA)
IA No: DWP0042	**Date:** 29/10/2013
Lead department or agency: DWP	**Stage:** Consultation
Other departments or agencies:	**Source of intervention:** Domestic
	Type of measure: Secondary Legislation
	Contact for enquiries: Nik Percival (020 7449 7623)

Summary: Intervention and Options

RPC Opinion: Awaiting scrutiny

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
Not yet quantified	Not yet quantified	£0 - 5m	YES	IN

What is the problem under consideration? Why is government intervention necessary Individuals saving into a pension scheme generally incur charges, usually levied as a percentage of their fund. As the value of their fund grows, the cumulative impact of these charges can over time become significant, and differences in charge levels across schemes can result in large differences in the income different individuals receive in retirement. However, information on charges is not always clearly disclosed and employers – who choose the workplace pension scheme their employees pay into - are often unaware of the charges their employees pay. Furthermore, it may not often be their key concern when selecting a pension scheme. With automatic enrolment projected to result in 6-9 million people newly saving or saving more into a pension, and those saving through automatic enrolment having little choice over the scheme they save into, it is important that individuals are protected against excessively high charges.

What are the policy objectives and the intended effects? To protect individuals from incurring excessively high charges on their retirement savings, particularly where they have not made an active decision on their scheme, and through this to ensure the long-term success of the Government's reforms to help people secure an adequate income in their retirement. This will contribute to the Coalition's commitment to ensuring that the pensions system is fair and affordable, and protects pensioners against erosions in the value of their pensions.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base) Three options have been considered in this IA – 1) do nothing; 2) improve disclosure of pension scheme charges 3) set a charge cap on the default fund in qualifying pension schemes which are used for the purposes of automatic enrolment.

Doing nothing is not a reasonable option. There are a range of charges across workplace pension schemes, and no guarantee that higher charging schemes offer individuals better investment returns. There is a risk that employers will continue to use high-charging schemes for automatic enrolment, making individuals worse off than they otherwise could be.

Option 2 should make employers more aware and informed of the charges their employees incur, but is expected to have only a limited effect on employers' behaviour when choosing a scheme: many employers – particularly smaller ones – may have trouble using the information, and charges to members may not be their main concern – so many individuals may continue being enrolled into high charging schemes. As a result, giving extra information is by itself not sufficient to meet the Government's objective.

Therefore, whilst the Government is interested in exploring (during the consultation) what more can be done to improve transparency in pension scheme charges, and whether there is a role for Government to improve disclosure, it is also interested in a charge cap, as this may be the only reliable way of meeting the Government's objective. The Government is consulting on both measures before setting out its preferred option.

Alternatives to regulation have not been considered in this IA, as previous non-legislative approaches have had limited effect: to date only a handful of providers have responded to a previous challenge by the Minister for Pensions to lower charges.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:**

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date: 29/10/2013

Summary: Analysis & Evidence

Policy Option 1

Description: Do nothing

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	**High:** 0	**Best Estimate:** 0

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High				
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

n/a

Other key non-monetised costs by 'main affected groups'

n/a

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low				
High				
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

n/a

Other key non-monetised benefits by 'main affected groups'

n/a

Key assumptions/sensitivities/risks

Discount rate (%) 3.5

n/a

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	**Benefits:** 0	**Net:** 0	n/a	n/a

Summary: Analysis & Evidence

Policy Option 2

Description: Improve transparency and disclosure of pension scheme charges

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate:

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High	0		19	**172**
Best Estimate	0		19	**172**

Description and scale of key monetised costs by 'main affected groups'

There will be ongoing administrative costs for pension providers from producing and sending out information on charges to employers and pension scheme members.

Other key non-monetised costs by 'main affected groups'

n/a

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low				
High				
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

n/a

Other key non-monetised benefits by 'main affected groups'

Employers will receive clearer and better information on scheme charges. This will ensure they are more informed, and are likely to have more trust in their pension scheme provider.

Employers may find it easier to compare charge levels, potentially reducing the costs of selecting a scheme. In some cases this may mean individuals are enrolled into more appropriate schemes.

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

Ongoing administrative costs are likely to be over-estimated, as many providers plan to voluntarily send out information on charges. The estimated cost of sending out information is also based on paper-based communications - providers have the opportunity to disclose information to employers and individuals through electronic communications, which should reduce costs. Costs will also be lower for schemes choosing to adapt existing communications rather than sending out new additional information.

There is a risk that improved disclosure of scheme charges will have little effect on employers' choice of scheme, and that some individuals will - with little other choice – either simply remain in high-charging schemes, or opt-out of pension saving altogether, resulting in an increase in the number of individuals facing an inadequate income in retirement.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: n/a	**Benefits:** n/a	**Net:** n/a	n/a	n/a

Summary: Analysis & Evidence

Policy Option 3

Description: Charge cap on default funds in qualifying pension schemes

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate:

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	16.0			15.0
High	55.5			52.0
Best Estimate	20.5			19.0

Description and scale of key monetised costs by 'main affected groups'

There is a cost to employers from finding alternative pension provision. This will arise if they have existing pension provision that they were intending on using to meet their automatic enrolment duties, but are no longer able to because the schemes' charges exceed the level of the cap.

The size of the costs depend on the level at which the charge cap is set. The lower the cap the higher costs, as more employers would be prevented from using existing provision to fulfil their automatic enrolment duties. The Department's best estimate is based on a charge cap of 1%, but has also provided a higher cost estimate based on a 0.75% cap.

Most employers affected are expected to be small (largely because most employers are small). It is necessary to include small employers, because high charges are more likely in small schemes, and the majority of small schemes are found in smaller organisations – four fifths of occupational schemes with fewer than 20 active members are in organisations with fewer than 20 employees.

Other key non-monetised costs by 'main affected groups'

Some providers offering higher-charging schemes are expected to lose business to others offering lower-charging multi-employer schemes.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low				
High				
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

n/a

Other key non-monetised benefits by 'main affected groups'

The main benefit of a charge cap is that individuals will benefit from incurring lower charges on their pension savings than they otherwise would have. Everything else being equal, this will increase the income they receive in retirement. The increase in retirement income will vary across individuals and will depend on the level of charges they otherwise would have incurred, the period of time they spend in the scheme, the level and persistency of their contributions and the level of fund growth.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

For individuals directly affected by the charge cap, there is a risk that the benefit of lower charges will be offset by lower investment returns – if lower charges are associated with lower investment performance. There is currently little evidence to indicate this will generally be the case, but the Government will be seeking further evidence from stakeholders.

For individuals in other schemes not directly affected by the charge cap, there is a risk that over time they will incur higher charges than they otherwise would, if providers seek to level up charges on new schemes they offer to compensate for the impact of the charge cap.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 1.9 - 5	**Benefits:** 0	**Net:** 1.9 - 5	Yes	IN

Background

1. The Pensions Act 2008 introduced a duty on employers to automatically enrol employees into a pension scheme. These duties affect the largest employers first, but will be rolled-out gradually to medium-sized and then the smallest employers by 2017. The Government projects that this will result in 6-9 million people newly saving or saving more into a pension, generating an extra £11 billion a year in pension savings[1].

2. Employers can choose which scheme to enrol their employees into, and can use an existing scheme if they have one. Most employers are expected to use defined-contribution schemes to satisfy their requirements.

3. The pension income an individual will receive from these schemes is not guaranteed (unlike a defined-benefit scheme) and depends on the amount of money contributed, the performance of the funds in which the money has been invested, and what charges are deducted. The eventual income an individual receives in retirement will therefore depend on the particular scheme that they save into.

4. To help employers choose a scheme which gives their employees a good deal, the Government have set up a low-cost pension scheme in the form of the National Employers Saving Trust (NEST). The Pension Regulator have outlined six principles it wishes all schemes used for automatic enrolment to encompass – including ensuring schemes are "*designed to be durable, fair and deliver good outcomes for members*"[2], and issued guidance on selecting a good automatic enrolment scheme[3].

5. However, beyond certain basic conditions – including a requirement to have a default investment option - there is no requirement on pension providers or employers to ensure that the schemes into which employees are automatically enrolled and save into meet certain quality standards.

6. To address this, the Department published a call for evidence in July 2013 into the quality standards in defined-contribution workplace schemes, and introduced a provision in the Pensions Bill currently being considered by Parliament to set quality standards for certain schemes.

7. The call for evidence set out some illustrative approaches to possible legislative minimum standards for scheme governance, administration and investment options. It announced that a further consultation on the particular issue of pension scheme charges would be published in the autumn, following the investigation into the workplace pension market by the Office of Fair Trading. The Department is now consulting on the issue of charges, including proposals for a charge cap on the default fund in qualifying pension schemes.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223031/wpr_digest_0712.pdf
[2] http://www.thepensionsregulator.gov.uk/professionals/defined-contribution.aspx
[3] The Pensions Regulator, July 2013, A *quick guide to selecting a good quality pension scheme for automatic enrolment* http://www.thepensionsregulator.gov.uk/docs/selecting-a-good-automatic-enrolment-scheme.pdf

Problem under consideration / Rationale for action

8. Most individuals saving into a pension scheme will pay an annual management charge (AMC) - which is usually expressed and levied as a percentage on the total value of the fund.

9. As the value of an individual's pension pot grows, the cumulative impact of these charges can over time become significant, and differences in annual management charges between schemes can result in large differences in the income different individuals receive in retirement.

10. A number of previous studies[4] have shown the extent to which higher charges can reduce the value of an individuals' pension pot. For example, the Pensions Policy Institute (PPI) found that even at the level of the stakeholder cap (1.5% for the first ten years, and 1% thereafter), charges could have a large impact – reducing private pension income by 13% compared to the NEST combined charge[5].

11. Chart 1 presents the results of DWP modelling into the impact that different annual management charges could have on the private pension income received in the first year of retirement. Based on the example below, an individual who saves for their entire working life could – everything else being equal – see a private pension income that is over £1,800 a year (25%) lower[6] if they saved in a scheme with a 1.5% AMC compared to one with a 0.5% AMC.

12. Whilst stakeholder pension schemes (introduced in 2001) have their charges capped at 1.5% for the first ten years, and at 1% thereafter, the latest evidence suggests that most pension schemes now have charges below this level. According to the Department for Work and Pensions' 2012 *Pensions Landscape and Charges* survey, average charges were 0.71% in trust-based schemes and 0.95% in contract-based schemes – below the level of the stakeholder charge cap. Meanwhile, the National Association of Pension Funds (NAPF) found an average AMC of just 0.46% in their 2012 Annual Survey.

13. Furthermore, there is evidence that charges have been falling over time, first in response to the introduction of stakeholder pensions[7], and more recently as new schemes have entered the market following the introduction of automatic enrolment. For example, the ABI have found that the average customers in schemes newly set up for automatic enrolment faced an AMC of 0.52%, whereas in pre-existing GPP schemes the average customer faced an AMC of 0.77%[8]

14. However, there remain a wide range of charges (the schemes covered in the NAPF annual survey had charges ranging from just 0.1% to 1.3%[9]) - and at least some schemes continue to offer much less competitive rates. For example, the DWP charges survey found that 10% of employers with contract-based schemes and 6% with trust based

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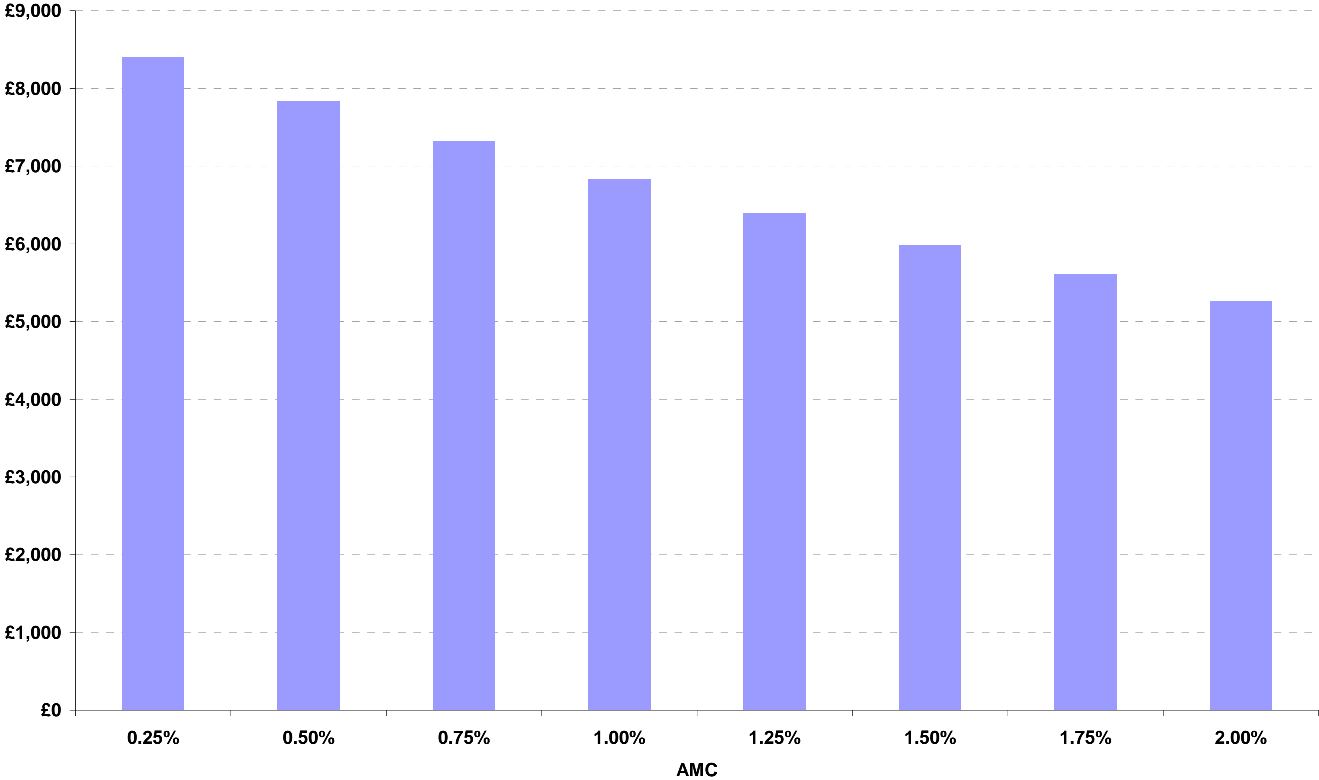
[4] For example, Johnson P, Yeandle D, and Boulding A, October 2010, *Making Automatic Enrolment Work*
[5] Pensions Policy Institute, 2012, *Closing the gap: the choices and factors that can affect private pension income in retirement*
[6] In 2013 earnings terms
[7] Wood A, Leston J, and Robertson, M, 2009, *Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries*, DWP Research Report 591
[8] Association of British Insurers, June 2012, *Time to Act: Tackling our Savings Problem and Building our Future*, page 12 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/Time%20to%20Act.ashx
[9] National Association of Pension Funds, 2012, *Annual Survey 2012*

schemes reported an AMC of more than 1%[10] (see Chart 2 below), and the ABI found a small handful of schemes charging above 2%[11].

Chart 1: Impact of Annual Management Charges on annual private pension income (£ expressed in 2013 earnings terms)



Source: Based on DWP modelling
Assumptions:
1) Individual contributes to scheme every year from age 22 until retirement, aged 68
2) Contributes £1,500 a year, growing at 4% per annum.
3) Nominal fund growth of 7% per annum.
4) Annuity rate of 6%. No lump sum taken.
5) Earnings growth of 4% per annum.

What drives the variation in charges?

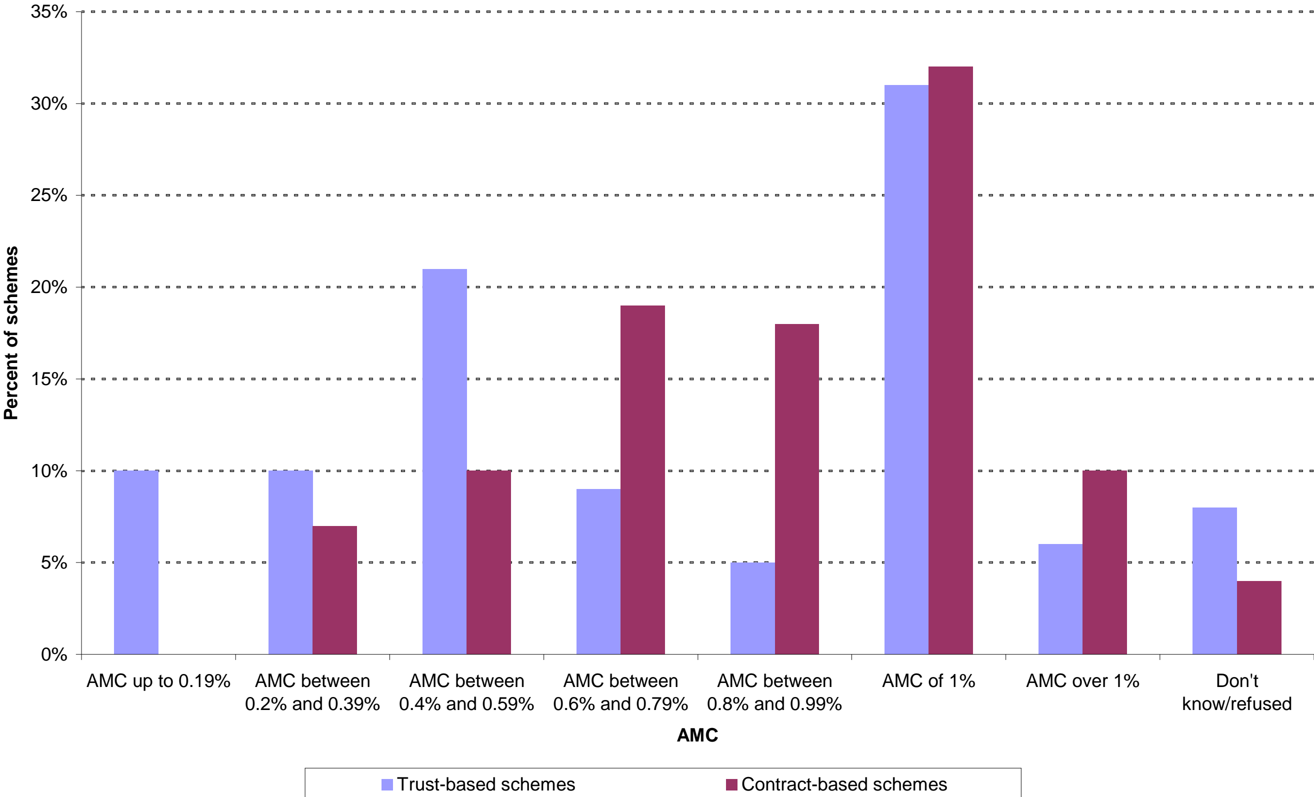
15. It is not clear that higher annual management charges tend to reflect higher quality schemes – for example, in the form of greater investment returns. Whilst this will be the case in some instances, the Department is unaware of evidence showing that it is generally the case (or even comparing charges and scheme performance more generally).

16. A couple of older studies found little relationship between scheme performance and scheme charges. A report by the Pensions Institute in 2000 concluded that there was “no support, either in theory or on the basis of existing evidence, for the argument that high charges can be justified by the promise of the superior investment performance that such

[10] A small proportion of employers reported that they did not know the charges their members paid, or refused to say - at least some of these are also likely to have charges above 1%.
[11] Association of British Insurers, June 2012, *Time to Act: Tackling our Savings Problem and Building our Future*, page 12 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/Time%20to%20Act.ashx

high charges might be able to purchase". And in 2002, the Sandler review concluded that "charges for near-identical products can differ widely". However, since both reports were published over a decade ago, and before the introduction of stakeholder pensions (since when charges have steadily fallen), it is not clear to what extent their conclusions still hold true. The Department will be looking for further evidence during its consultation.

Chart 2: Range of AMCs paid by members of trust- and contract-based schemes



Source: DWP Pension Landscape and Charging survey 2012

17. Either way, it is likely to be difficult for employers and individuals to make an informed decision over the quality of pension schemes, given that investment performance can only be assessed over the long-run, and will therefore not be known for many years, and possibly not until retirement.

18. Notwithstanding potential variations in quality, a key factor behind the variation in charges appears to be differences in scheme size – with the DWP charges survey finding that this was the greatest determinant of the AMC. Employers with 12-99 members reported an average AMC of 0.82% whereas schemes with 1,000 or more members said members paid less than 0.5% on average[12] (see Table 1). This trend was corroborated by data collected from pension providers on the schemes they had sold in the last 12 months.

19. Given that only the largest employers have so far been subject to automatic enrolment the current low charge levels observed in schemes newly set-up for automatic enrolment

[12] Wood A, Wintersgill D, and Baker N, 2012, *Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers*, DWP Research Report 804

could in large part reflect the size of those scheme. By way of indication, the charges observed by the ABI for individuals in schemes newly set up for automatic enrolment (0.52%) is remarkably similar to the charges found in the largest schemes in the DWP charges survey. If these lower charges are due to the size of the scheme, there is a risk that employees working for smaller employers could incur higher charges as they are automatically enrolled in the future.

20. The higher charges found in smaller schemes appears to reflect in large part the fact they are more costly to set-up and run, and are unable to benefit from the economies of scale which larger schemes can. For example, research by Capita Hartshead has found that schemes with more than 50,000 members report costs of around £10-30 per member, whilst schemes with fewer than 1,000 members report costs of around £200 per member[13].

Table 1: AMC levels and scheme size, compared to average AMC

	12-99 members	100-999 members	1,000+ members	Average for all schemes
Trust-based	0.82	0.66	0.48	0.71
Contract-based	-	0.82	0.48	0.95

Source: DWP Pension Landscape and Charging survey 2012

21. Many of the higher charges are found in older "legacy" schemes[14], and employees working for smaller and medium-sized employers should now be able to access lower charges through newer larger multi-employer schemes.

Factors affecting choice of scheme

22. The problem is that individuals do not choose the workplace pension scheme they are enrolled into – their employers do – and because their incentives are not necessarily aligned, employers may choose a scheme which is not the most appropriate for their employees.

23. Research has shown that a key factor in scheme choice for many employers is likely to be a preference for a simple solution that is easy to implement, especially amongst employers who are new to providing workplace pensions[15]. For example, the NAPF and B&CE[16] found that whilst many employers were motivated by keeping staff happy, and smaller employers were often the most concerned about the welfare of their employees, the very smallest employers tended to be most concerned with survival and minimising the costs of automatic enrolment to them as an employer.

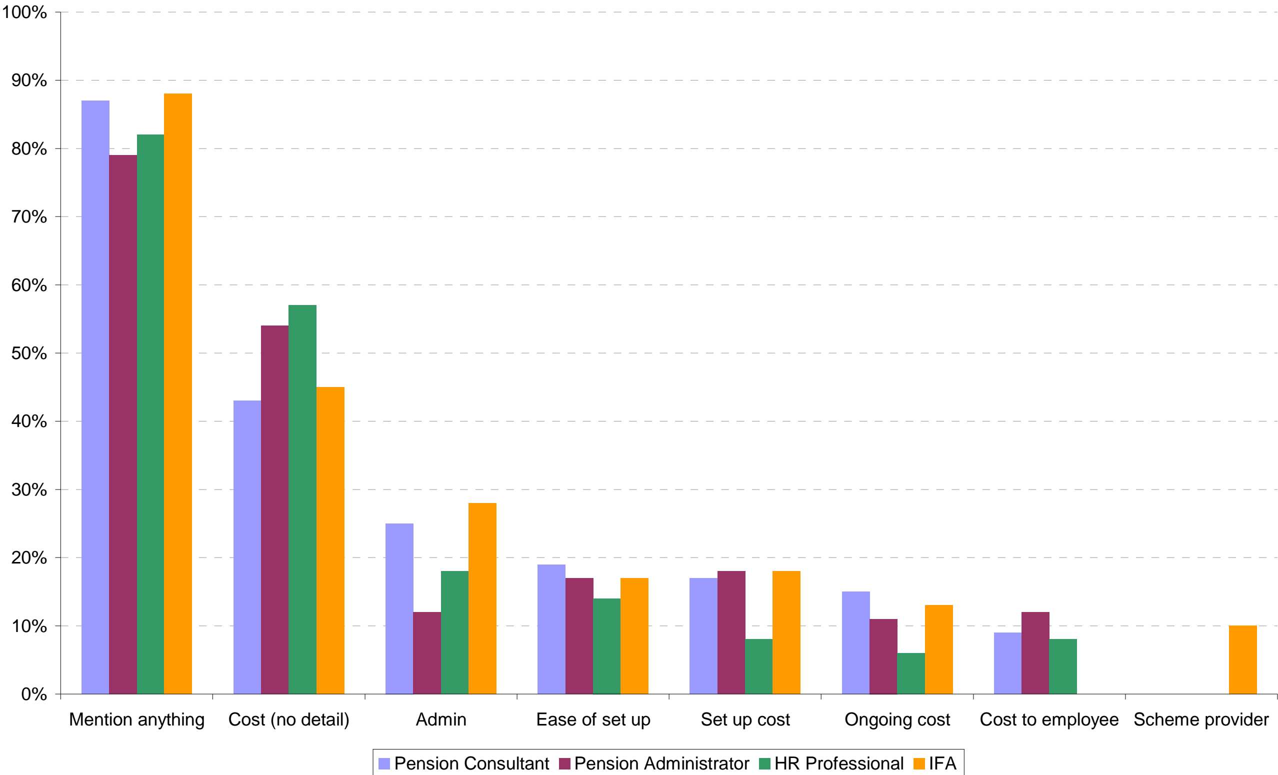
24. Research by the Pensions Regulator has found that the majority of intermediaries - i.e. consultants, IFAs, administrators and HR professionals - believed that cost would be the employer's main consideration when selecting a scheme. This factor was mentioned most often by all intermediary types – ranging from 43% of pension consultants to 57% of HR

[13] Capita Hartshead, May 2010, *17th Annual Pension Scheme Administration Survey 2010*
[14] Harrison D, Blake D, and Dowd K, October 2012, *Caveat Venditor*, Pensions Institute and Cass Business School
[15] Woods A, Spinks S, Leong J, and Reeve K, 2010, *Likely treatment of different types of worker under the workplace pension reforms: Qualitative research with employers*, DWP Research Report 662
[16] NAPF and B&CE, September 2012, *Telling Employers about DC Pension Charges: Research*

professionals, whilst only 8-12% cited cost to the employee would be the main factor[17]. See Chart 3 below. There is a clear risk that selecting a scheme on the basis of ease of implementation or cost to the employer could result in an expensive and inappropriate scheme for employees.

25. This principal agent problem - whereby the employer "buys" the pension scheme, but the individual is the end "customer" – is confounded by the fact most employers do not know what charges their members pay. The 2012 DWP charges survey[18] found that employer's awareness of the charges that their members paid was low, with only around a third of employers with trust-based or contract-based schemes aware that members paid any charges at all.

Chart 3: Considerations when selecting a scheme



Source: The Pensions Regulator, *Intermediaries' awareness, understanding and activity relating to workplace pension reforms, Spring 2012*

26. Awareness of charges was found to be lowest amongst smaller employers. They were also generally unaware that it was possible to negotiate charges with providers, and struggled to understand the impacts of percentage based charges on employees' pension pots – preferring flat-rate charges on the basis of their simplicity (even if such charges can often have a detrimental impact on individuals with smaller pots)[19]. With such a limited

[17] The Pensions Regulator, August 2012, *Intermediaries' awareness, understanding and activity relating to workplace pension reforms, Spring 2012*
[18] Wood A, Wintersgill D, and Baker N, 2012, *Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers*, DWP Research Report 804
[19] NAPF and B&CE, September 2012, *Telling Employers about DC Pension Charges: Research*

knowledge of charges, there is an increased risk that employers do not adequately take into account the effect of charges on members when selecting a scheme.

27. Contributing to this lack of understanding is a lack of transparency in the information supplied by pension providers. At present there are limited requirements on schemes to disclose the charges they impose on members. Providers of stakeholder pensions are required to disclose deductions for charges made from an individual's pot, and contract-based schemes are required by the Financial Conduct Authority (FCA) to provide illustrations that show the effect of charges. However, there is normally no requirement on trust-based schemes to disclose charges, and whilst regulations require all money purchase schemes to provide annual statements to members, there is no requirement to show information about charges on this.

28. Research by the NAPF found that many employers feel that the structure of pension charges is not well explained nor transparent in how it is presented, whilst smaller employers felt charges were deliberately unclear with a perception that providers were obscuring certain add-on charges behind technical jargon[20].

The case for change

29. There is therefore, a strong rationale for Government to address both the principal-agent problem and informational asymmetries outlined above. Without intervention, individuals could end up being a lot worse-off than they otherwise could be (and similar individuals in other pension schemes will be).

30. A number of steps have already been taken to address the issue of both high charges and lack of transparency. Last year the Minister for Pensions challenged the pensions industry to review charges in legacy schemes which they wouldn't offer to customers today. Meanwhile, in December the Pension Regulator warned employers against using "small" defined-contribution arrangements and high-charging legacy schemes for automatic enrolment, and encouraged the use of larger-scale schemes which can deliver low charges through economies of scale and better governance.

31. The Department's Default Fund Guidance, published in May 2011, made clear that default funds used for automatic enrolment should disclose a breakdown of overall charges, making clear the effect that charges will have on member outcomes.

32. The ABI recently launched an agreement on the disclosure of costs and charges to members, with signatories committing to disclosing all charges and costs in a consistent way to members – to date, fourteen of the UK's biggest pension providers have signed up to the standards set out. They have also developed an online pensions calculator, available via the Pensions Advisory Service (TPAS) website, to help employers compare different charge levels, and look at the impact of charges on the pension pots of their employees[21]. Meanwhile, the NAPF has also led an industry-wide group to develop a Code of Practice on the transparency of charges for employers, which it published in November.

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[20] NAPF and B&CE, September 2012, *Telling Employers about DC Pension Charges: Research*
[21] http://www.pensionsadvisoryservice.org.uk/pension-charges-calculator

33. However, there remains a case for action to address the risk remains that employers will automatically enrol their employees into high-charging pension schemes.

34. To date only a handful of providers have responded to the challenge to lower charges in legacy schemes, and many employers responding to the latest Employer Pensions Provision Survey 2011 said they intended to use existing provision for automatic enrolment – 60 percent of those who already offer a form of workplace pension provision planned to keep all current members in their scheme, and 49 per cent planned to use the existing scheme for non-members and new employees.

35. Even if employers do set up a new scheme, in some cases their employees may continue to incur high charges. As indicated above, there is a risk that charges could increase as smaller employers are staged into automatic enrolment in the coming years – particularly if they use smaller schemes which are more costly to run. Even if alternative low charging multi-employer schemes exist, there is no guarantee that employers will use these if they are unaware of the charges their members pay or if their primary concern is their own costs.

36. Furthermore, once employers have chosen a scheme, many stick with it – with the average trust-based scheme set up in 1993 and the average contract-based scheme set up in 2001[22] - meaning employees could end up being locked into high-charging schemes.

37. In summary, individuals are enrolled into schemes which are chosen by their employer and which when choosing many employers do not consider the charges that individuals pay, with the consequence that many individuals may be automatically enrolled into schemes which have higher charges - and end up receiving much lower income in retirement - than they otherwise could get.

38. With automatic enrolment projected to result in 6-9 million individuals newly saving or saving more into a pension scheme, many of whom are unlikely, at least initially, to engage with their pension saving, it is important that the schemes they are enrolled into offer value for money.

Policy objectives

39. When considering pension scheme charges, the Government's key objective is to protect members from incurring excessively high charges on their retirement savings, particularly where they have not made an active decision on the scheme they are saving into.

40. This will help to ensure that the Government's steps to get people saving for their retirement, through automatic enrolment, are successful, and help individuals secure an adequate income in retirement.

41. This contributes to the Coalition's commitment in its mid-term review to ensure that the pensions system is fair and affordable, and protects pensioners against erosions in the value of their pensions[23].

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[22] Wood A, Wintersgill D, and Baker N, 2012, *Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers*, DWP Research Report 804

[23] http://assets.cabinetoffice.gov.uk.s3-external-3.amazonaws.com/midtermreview/HMG_MidTermReview.pdf

Description of options considered

42. This Impact Assessment considers three options:

Option 1: Maintaining the status quo (Do nothing)

43. Under this scenario, the Department and the Pensions Regulator would continue to encourage and support employers to use low charging schemes to fulfil their automatic enrolment duties, and NEST would continue to provide competitive pressure on keeping charges low, but there would be no additional requirement on providers to disclose charges to employers or individuals, and no requirement on employers to ensure members did not incur excessive charges.

44. This option serves as a baseline option for assessing the impact of the other options considered. For the purposes of the IA, this option therefore has zero costs and benefits (relative to itself).

Option 2: Introducing a statutory requirement on schemes to disclose charges

45. Existing DWP legislation requires private pension schemes to disclose prescribed information to members and others. Rather than rely on schemes to provide information in line with the guidance set out by the Department and encourage them to voluntarily sign up to the codes of practice developed by industry bodies, the Government could place a statutory requirement on schemes to disclose information about charges to employers and individuals.

46. The types of information that schemes would be required to provide, and the manner in which it is provided, would build on existing arrangements, including the code of conducts already developed – but would be standardised to make it easy for employers and individuals to compare charges across schemes.

47. This requirement would be on pension schemes, and apply to all defined-contribution workplace pension schemes from April 2014.

Option 3: Introducing a charge cap on default funds in qualifying schemes.

48. Alongside the duty to automatically enrol employees into a qualifying pension scheme, the Pensions Act 2008 also included a reserve power to cap charges in qualifying schemes. An amendment was made to the Pensions Bill 2011 to extend this power to those not actively contributing to a pension scheme.

49. Making sure that charges do not exceed the level of the cap would become part of the criteria for schemes to qualify as an automatic enrolment scheme. It would be the employer's responsibility to ensure that the scheme they choose to meet their automatic enrolment duties meets the criteria.

50. The requirement would only apply to the default fund in qualifying money-purchase schemes used for the purposes of automatic enrolment. It is envisaged that the cap will

apply from April 2014. Any employers already subject to automatic enrolment will be required to make sure that their schemes charges do not exceed the cap from a specified date (the Government propose April 2015).

51. The Department is consulting on which charges should be covered by the cap but is proposing to specify a broad, all encompassing definition of the different charging elements to mitigate against avoidance risk and 'innovation in charging' to elude a cap. The Department is also seeking views on how to treat combination-charge structures.

52. Two levels for the cap are considered in this Impact Assessment:
- 1% of funds under management
- 0.75% of funds under management

53. The Government is consulting on a third option - whereby a cap of 0.75% would apply to schemes unless they satisfied a series of conditions in respect of scheme quality, in which case a higher 1% cap would be available. This option might achieve the benefits of the lower cap, whilst addressing some of the risks associated with it (see below) - however this depends on what features schemes would be required to demonstrate in order to levy the higher charge. The Government is consulting on what conditions stakeholders would expect to see for schemes to qualify for a higher cap. An assessment of this option will be provided following consultation - once stakeholders' views on appropriate conditions have been gathered.

Options not considered

54. This Impact Assessment is restricted to the issue of pension scheme charges and options which directly address their level and the way they are disclosed to employers and individuals. It does not consider options to strengthen or improve the governance of pension schemes, as recommended by the Office for Fair Trading in its study into the defined-contribution pensions market (which may have an indirect affect on some of the issues considered here).

55. The Department is exploring governance structures and standards separately, issuing a call for evidence into pension scheme quality standards in July 2013. The Government will look to bring forward fuller proposals in this area in due course.

Preferred option

56. The Government are consulting on these options before setting out its preferred option for protecting people from being enrolled into schemes which have high charges.

57. Doing nothing would continue to leave individuals at risk of being enrolled by their employer into a high-charging workplace pension scheme, with no guarantee this will be rewarded with higher investment returns. To protect individuals against this, there is a need to address both the information and principal-agent problems identified above.

58. Option 2 should make employers more aware and informed of the charges their employees incur, but does not address the principal-agent problem. Furthermore, some employers may struggle to understand and act upon the information they would receive.

Therefore, based on the evidence currently available, giving extra information to employers or individuals may not by itself be sufficient to meet the Government's objective of ensuring that individuals do not incur excessive charges. Nonetheless, the Government is interested in exploring during the consultation how disclosure could be improved.

59. Option 3 would generate additional costs for employers who need to arrange a new pension scheme, but would result in a large number of individuals benefiting from lower charges. This could result in significant increases in the income which some individuals receive in retirement.

60. The Government recognises that retirement outcomes do not just depend on charges – they also depend on the quality of the scheme, its governance and investment returns – and if individuals 'get what they pay for' such that higher charges are rewarded by better investment performance, there is a risk that the benefit of lower charges is offset by lower fund growth and individuals could be little or no better off.

61. The Department is not aware of any data systematically comparing pension scheme charges and pension scheme performance. From the evidence available, it appears as if other factors – such as scheme size – may be a more important determinant of charge levels. However, given the importance of scheme returns for individual outcomes, the Department is seeking further evidence on this, and would welcome any data or information from stakeholders.

62. By using its provisions in the current Pensions Bill to set standards for certain schemes the Government will be able to limit the extent to which schemes cut back on administration, governance, and levels of investment management to offset the reduction in charges, and in turn protect individuals against the risk of being enrolled into low quality schemes.

Impact Assessment Stage

63. This is a consultation-stage Impact Assessment. It presents an initial assessment of the impacts of a charge cap and of improved disclosure of charges, based on the information currently available, and the proposals set out in the Government's consultation. It is consistent with and reflects the current stage of policy development[24].

64. As indicated at various points below, there is currently insufficient evidence to fully assess all of the impacts of a charge cap. The Government intends to use the consultation to gather the further evidence needed to inform a fuller impact assessment.

65. A full IA will be produced once stakeholders have been consulted, and decisions are made on a number of issues – including the level of any cap and reporting requirements for schemes. This will also take account of the outcome of the Government's call for evidence into scheme quality.

[24] http://www.bis.gov.uk/assets/BISCore/better-regulation/docs/I/11-1112-impact-assessment-toolkit.pdf

Evidence base

66. The DWP's primary source of information for measuring the charges levied on pensions is the *Landscape and Charges* survey. The research is carried out by an independent research organisation on behalf of the Department, and combines a survey of trust and contract based schemes with qualitative interviews, and data collection with 10 leading pension providers to provide context and deeper understanding of charging levels based on data for new schemes sold in the previous 12 months. The data collected from providers was used to check the accuracy of the information provided by employers – and the report found these to be closely matched.

67. Whilst the survey is a comprehensive measure of charge levels in DC schemes, the majority of respondents to the survey were found to be unaware that their members paid any charges at all. This inevitably generates a degree of uncertainty over its results, and limits the information that could be collected; for example, most respondents were unable to estimate the Total Expense Ratio (see below), and no estimates were provided for the level of contribution charges or flat-fees.

68. Despite the relatively low number of employers who were found to be aware of charges, the survey was nonetheless able to gain enough responses from employers to achieve statistically robust information on the AMC. Where employers were unaware of charges, they were not asked about the level of charges, in order to avoid including potentially inaccurate 'guesstimates'.

69. Whilst this doesn't entirely remove the risk of sampling bias in the results[25], information on Annual Management Charges has also been collected by a number of other organisations, including the OFT in their market study of workplace DC pensions, the NAPF in their 2012 Annual Survey, the ABI, and Towers Watson in their 2013 survey of FTSE 100 companies' DC pension schemes – and these alternative sources have tended to broadly support the findings of the DWP figures.

AMC-only and combination charging structures

70. Whilst the majority of schemes (between two-thirds and three-quarters[26]) charge on an AMC-only basis, a minority of schemes set charges as a percentage of members' contributions or as flat fee per member – see Chart 4 below.

71. Contribution charges and flat-fees will affect different individuals in different ways - for example, a deferred member will by necessity incur no contribution charges, but could see their pot quickly eroded by flat-fees, particularly if the value of their pension savings is relatively small. In contrast, a contribution charge is likely to make a bigger impact on individuals who regularly make large contributions.

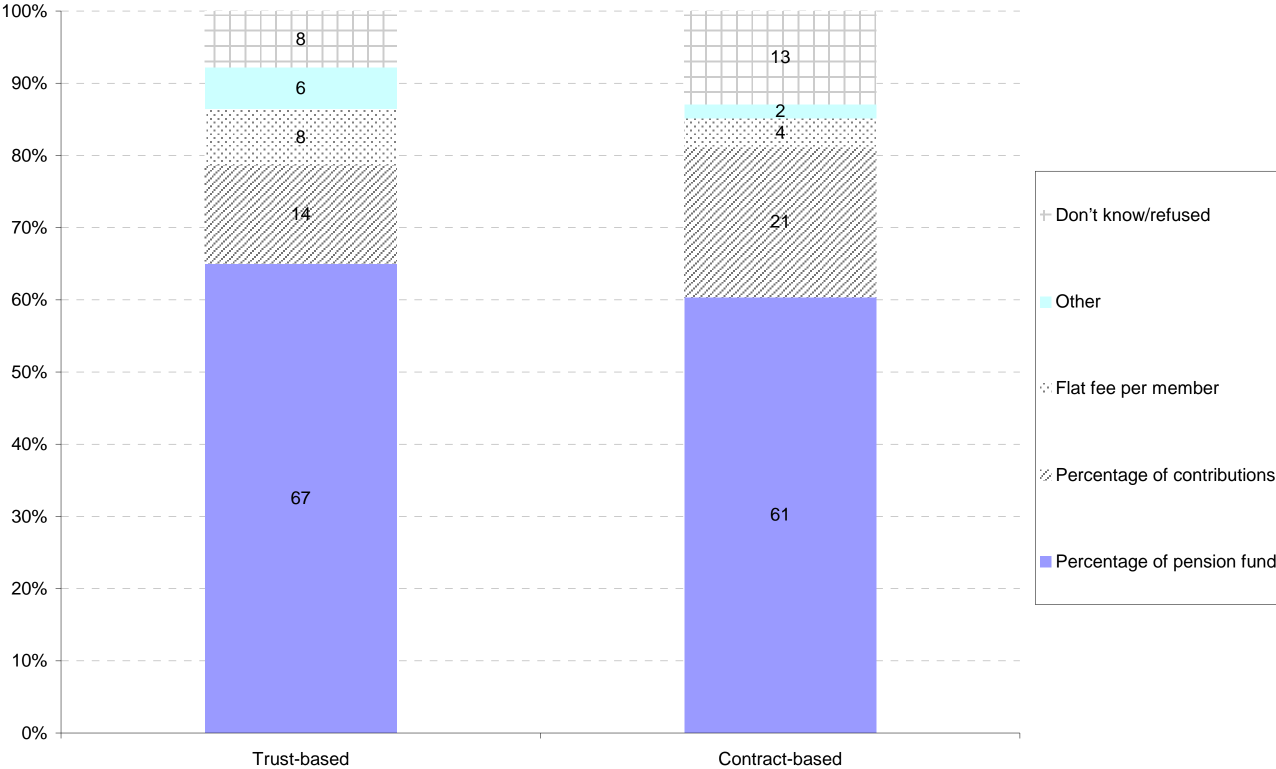
72. It is likely that over time – as the value of the individual's pension pot increases - an AMC will have a bigger impact on an individual's pot than contribution charges or flat-fees. For example, someone with a pension pot of £16,000 (the median wealth held in DC

[25] Charges may be higher for employers who weren't aware of charges

[26] The latest DWP *Pension Landscape and Charging Survey*, 67 per cent of trust-based schemes and 61 per cent of contract-based schemes reported charges were made as a percentage of the member's fund per annum. Meanwhile, the NAPF 2012 Annual Survey found that 76% of schemes used an AMC.

pensions[27]), who contributes £2,500 a year would be charged £50 under a contribution charge of 2%[28], compared to £160 in a scheme with a 1% Annual Management Charge.

Chart 4: Type of charge structure applied



Source: DWP Pension Landscape and Charging survey 2012

73. Unfortunately, the surveys mentioned above do not provide detailed information on the range of combination charges, contribution charges or flat-fees levied by schemes. In the absence of such data, the Department has assumed for the purposes of estimating impacts that schemes which charge on this basis will be just as (but no more) likely to be affected by a charge cap as AMC-only structures. Meanwhile, the Department will be consulting on how to deal with these types of charge structures under a charge cap scenario.

Annual Management Charge and Total Expense Ratio

74. In most cases, the different surveys listed above only provide information on schemes' Annual Management Charges. In some cases there will be additional costs which are charged separately from the AMC – including audit, legal and custodial fees. The Total

[27] Office for National Statistics, July 2012, *Chapter 4: Pension Wealth 2008/10*
[28] Previous research for the DWP found that the overall mean charge per contribution was 2.08%. See Croll A, Vargeson E, and Lewis A, 2010, *Charging levels and structures in money-purchase pension schemes: Report of a quantitative survey*, DWP Research Report 630

Expense Ratio is a method of measuring the total costs associated with managing and operating a pension fund[29].

75. If all expenses are already included in the AMC levied by the provider, the TER will equal the AMC, but the Department understands that this is not always the case. Unfortunately relatively little information exists on the TER of pension schemes. The concept is defined by the FCA for collective investment schemes, and do not apply directly to pensions (although they may be given where a pension invests in unit trusts).

76. One source which attempted to measure the TER of schemes - the DWP Pension Landscape and Charging survey - found that only half of employers with contract- or trust-based pension schemes (who were aware their members paid charges) were informed of the TER by their pension provider, and only 20% of these could estimate it. In most cases they stated that the AMC and TER were the same, but around a third of employers with trust-based schemes reported it to be higher.

77. Meanwhile, respondents to the survey reported a number of additional member-specific charges outside the AMC, which could be levied in certain circumstances – for example, charges for certain fund choices, which were reported in 30 per cent of cases.

78. Accordingly, the Department is aware that a measure of charges which includes all costs and expenses, rather than just the Annual Management Charge, will in some cases be higher than the AMC observed in most existing data sources. As a result, a charge cap based on a more comprehensive measure than the AMC would in turn be expected to affect more schemes, employers and individuals than is estimated here, which uses information on the AMC. As part of its consultation, the Department will be seeking further evidence on charging levels and definitions.

Differential charging structures

79. Schemes can also have differential charging across members – most notably, in the form of active member discounts/deferred member penalties. Where this is the case, members who contribute to their scheme will incur a lower Annual Management Charge than those who no longer do.

80. The evidence available suggests that a minority of schemes currently adopt such a differential charging structure[30], but they have become more popular amongst employers in recent years[31]. Unfortunately no data exists on the AMC of schemes which operate an active member discount specifically, but where operated the average percentage point discount applied to the AMC is estimated to be 0.45-0.55%. This has been taken into account when estimating the impacts of a charge cap.

[29] They do not include all costs however – for example, investment charges such as initial exit and entry fees, brokerage commissions, bid-offer spreads and stamp duty.

[30] The OFT estimated that approximately 15 per cent of post 2001 contract-based schemes have Active Member Discounts, The DWP charges survey found that only 4% of employers with a trust-based scheme, and 16% of those with a contract-based scheme operated deferred member penalties, whilst the Towers Watson 2013 FTSE 100 DC Pension Scheme Survey found that 19% of employers surveyed operate a different charging structure for active members.

[31] The DWP Pension Landscape and Charging survey 2012 found that some of the very large providers had sold the majority of their GPPs with AMDs in the 12 months prior to the research - Wood A, Wintersgill D, and Baker N, 2012, *Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers*, DWP Research Report 804

Costs and benefits

81. The monetised and non-monetised costs and benefits on key groups are described below. Further details and commentary follows.

Table 2: Summary description of monetised/non-monetised costs and benefits

	Employers	Pension Industry	Individuals
Option 1: Do nothing	*No impact*	*No impact*	*No impact – although some individuals will continue incurring excessively high charges*
Option 2: Improve transparency and disclosure of charges	*No additional burdens on employers.* *They may be more informed of charge levels and structures, and could find it easier to compare charges across schemes.* *The available evidence indicates employers may have more trust in their pension providers, but that many could struggle to comprehend the information and that this will have little behavioural impact on their choice of scheme.*	*Ongoing administrative costs from sending information on charges.* ***Estimated annual ongoing costs of up to £23.5m a year by 2023*** *Costs are likely to be lower as a number of providers are already voluntarily providing this information. There should also be scope to reduce costs; for example, by using electronic communication.*	*Individuals may be better informed and have more trust in pensions, but may have difficulty putting this information into context or understanding what it means for their income in retirement, and even then are likely to have little option over the choice of scheme or the charges they incur.* *Some individuals may end up opting-out of their workplace pension scheme, and risk facing an inadequate income in retirement.*
Option 3: Charge cap on default funds in qualifying schemes	*Transitional cost from having to set up alternative pension provision.* ***Estimated transitional costs totalling £16 – 20.5m with a 1% cap and approx. £55m with a 0.75% cap****.*	*Some pension providers may benefit at the expense of others. Likely to be some consolidation in number of schemes – resulting in a smaller number of more efficient schemes, taking advantage of economies of scale.* *Introducing a charge cap will increase the level of capital insurers are required to hold in order to protect customers against the risk of insolvency.*	*250-350 thousand active members could benefit from lower charges with a 1% cap, and around 1.5 million with a 0.75% cap.* *The extent to which individuals gain depends on how higher charges are associated with better scheme quality, as well as the response of the pensions industry - some could see little or no benefit from lower charges if lower charging schemes have lower investment growth.* *Other individuals not directly affected by the cap may see higher charges than they otherwise would, if providers level up charges below the cap.*

Impacts of option 2

82. The Department's assessment of the impacts of improving transparency in pension scheme charges is set out in the following sections:
    - Direct costs to pension providers
    - Impact on employers and their choice of pension scheme.
    - Benefits and risks to individuals

DIRECT COSTS TO PENSION PROVIDERS

83. A new requirement to produce and send out standardised information on charges will generate new direct administrative costs for the pensions industry.

84. The information requirements should be relatively straightforward, easy to produce (if standardised), and readily available to providers (as it needs to be calculated in order to supply the information which pension providers send to employers at the point of sale and to individuals each year).

85. Based on previous consultation with the pensions industry, in the context of changes to the disclosure of information regulations[32], the Department has estimated that the cost of paper-based communications with individuals could be up to £1 per member.

86. On the basis of this unit cost, Table 3 presents the Department's estimate of the direct cost to providers from sending out summary information on charges. Costs have been up-rated in line with inflation, and for the purposes of these calculations, it is assumed information is sent to:
    a. private-sector employers at the point they select their workplace pension scheme (including those who use an existing scheme), as well as;
    b. every individual projected to be enrolled into a defined-contribution workplace pension scheme, once a year (whether actively contributing to it or not)

Table 3: Cost of sending standardised information on charges, £m, 2013/14 prices

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
11.5	15	16	17	18.5	21	23	23	23	23.5

Source: DWP modelling
Notes: Rounded to the nearest £0.5m

87. Costs increase steadily over the first few years as more employers and employees reach their staging dates for automatic enrolment[33].

88. In practice, there is good reason to suspect that the costs to the industry will be lower. Many of the large pension providers have already signed up to the Association of British Industry's agreement on charges disclosure, and based on discussions with the ABI, the Department expects that going forward the vast majority of members of contract-based

[32] https://www.gov.uk/government/consultations/occupational-and-personal-pension-schemes-disclosure-of-information-regulations-2013
[33] It is assumed that employers select their scheme six months before their staging date.

schemes would receive summary information on charges as a result of this agreement. The cost estimates in Table 3 do not account for this.

89. Furthermore, providers will have the opportunity to include this information in other communications they already send to employers and individuals. This will save them incurring some costs – such as postage (which are included in the £1 unit estimate). Alternatively, they could lower costs if information is sent electronically (although this may be limited by the extent to which providers have e-mail addresses for their members).

90. Whether communication is done electronically or through paper-based approaches, there may also be some transitional costs for providers in updating and changing their systems to include this information. Further discussion with the industry is required to understand the scope of this.

91. The Department would welcome feedback from pension providers on both the transitional and ongoing costs of sending out summary information on charges to employers and pension scheme members.

IMPACT ON EMPLOYERS AND THEIR CHOICE OF SCHEME

92. Under this proposal, there would be no direct cost imposed on employers, as they would have no duty to act upon the information provided. Nonetheless, the information should help address concerns raised over the lack of clarity and transparency in pension scheme charges, and the Department would expect many employers to at least consider what is provided.

93. Research for the NAPF, as part of their consultation on their Code of Conduct on charges, found that employers showed a strong interest in the concept of a standardised guide to pension scheme charges – particularly amongst the smallest employers who saw it as a useful starting point in selecting a pension provider.

94. One possible benefit of standardised information on pension scheme charges is therefore that it could make comparison of charges between schemes easier, which would in turn reduce the costs employers incur in selecting a workplace pension scheme.

95. However, even if employers do look at the information that pension providers send regarding charges, there is little evidence to suggest that it will affect the way most of them behave. Instead, there is reason to believe that the benefits of greater disclosure will be moderated to a large extent by the underlying problems identified above[34]. In particular, if employers' are primarily motivated by the cost and ease of implementing a workplace pension scheme, information which makes it easier to understand and compare the charges across schemes is likely to have only a marginal impact on their decision.

96. Furthermore, the research carried out for the NAPF found that the majority of micro employers (which make up the majority of employers, and those most at risk of high pension scheme charges) struggled to comprehend the information set out in the prototype guide they were provided[35]. For employers who have difficulty comparing and

[34] See paragraphs 22-28
[35] NAPF and B&CE, September 2012, *Telling Employers about DC Pension Charges: Research*

understanding the impact of percentage-based charges, an information-based approach is likely to have little effect.

BENEFITS AND RISKS TO INDIVIDUALS

97. In principle, ensuring individuals are fully informed about the charges they incur should better enable them to engage with their pension and make better decisions over whether and how much to save.

98. Evidence suggests that individuals would welcome greater disclosure of charges. Previous research carried out for the DWP found that whilst information on scheme charges might not be essential for individuals when making decisions over whether or not to remain in a workplace pension scheme, it was part of the supplementary information which they would like to have, as it would make them feel they were making a better informed decision, and feel more confident that the decision they made was the correct one. Even if they did not read this information, individuals felt its provision demonstrated a transparent and trustworthy process[36].

99. However, beyond increasing trust and confidence, there is little evidence to suggest that most individuals will engage with the information provided. The same research found that despite wanting the information, respondents differed considerably in how they would deal with it, with some unlikely to read it at all.

100. Furthermore, even if the do read it, individuals will be constrained in their ability to act upon the information they receive. Because the employer chooses their workplace pension scheme, individuals will not have the option to choose a different pension provider if they think it will offer them a better return. Saving into a personal pension scheme (or ISA or other investment) instead does not appear to be a reasonable substitute – particularly since the individual would forgo the contribution the employer is legally obliged to make to their workplace pension scheme if they opt out of it.

101. Therefore, if employers do not act upon the information provided, some individuals are likely to remain in high charging schemes. Alternatively, with more information about the charges they incur, and with little other choice than to remain in or opt out of the scheme, there is also a risk that some individuals will choose to stop saving into their employer's workplace pension scheme, which in turn will increase the number of individuals facing an inadequate income in retirement.

Impacts of option 3

102. The Department's assessment of the impacts of capping pension scheme charges in the default fund of qualifying schemes is set out in the following sections:
- Direct costs to employers
- Impact on the pension industry and the supply of pension provision.
- Benefits and risks to individuals

[36] DWP Research Report No 540, *The information people may require to support their decision to remain in, or opt out of, a workplace pension*, 2008

103. The IA concludes with a discussion of the overall Net Present Value (NPV) of a charge cap, setting out the further information the Department will be seeking to gather before quantifying this. An early estimate of the equivalent annual net cost to business (EANCB) for One-in-Two-out purposes is provided.

DIRECT COSTS TO EMPLOYERS

104. Because it would be the employer's responsibility to ensure that its scheme's charges do not exceed the level of the cap[37], the direct impact will fall on them. In particular, those employers who intend to use an existing scheme for automatic enrolment will incur costs from having to find and set up alternative provision if the charges in that scheme exceed the level of the cap.

105. This cost arises because when considering the administrative costs to employers of automatic enrolment, the Department estimated costs to be lower if firms used an existing scheme, relative to having to set up a new scheme – this reflected the fact they would already have the necessary systems in place. By preventing some firms from using an existing scheme – where charges are too high – the Government would therefore be imposing an additional direct cost on employers.

106. There will be minimal impacts on employers who plan to use existing provision if their charges do not exceed the level of the cap. They will incur some small administrative costs in confirming that this is the case, but in most cases the Department expects this to be straightforward, and beyond this no further action would be required.

107. Similarly, the Department does not anticipate a significant additional cost for firms who do not have, or do not intend using, existing pension provision. It is recognised that for some, the process of finding a scheme may become a more time-consuming and costly process when an additional charge cap requirement is added – as employers may have to go to a number of providers before finding one who is willing to offer them a scheme within the level of the cap. However, the Department understands there are a number of pension providers offering schemes with charges at or below the level of the two charge caps considered here, including the large multi-employer schemes set up for automatic enrolment. Furthermore, close to half of firms with no current workplace pension scheme who said they knew what scheme they intend to use for automatic enrolment indicated that they would enrol all employees into NEST[38]. Search costs may even reduce for some employers as the pool of schemes from which they can choose may shrink.

108. The cost to employers of familiarizing themselves with this additional requirement should also be small. Most employers will be able to do so when they familiarise themselves with the other details of automatic enrolment. Research by the Pensions Regulator has found that whilst the vast majority of employers are now aware of their requirement to automatically enrol their workforce into a pension scheme and contribute to it, most small and micro employers do not yet generally understand the detail of automatic enrolment, and most employers had not yet started to plan for it – most probably because they are not due to do anything for a couple of years. Many employers plan to "leave it as late as

[37] Rather than providers – as in the case of stakeholder pensions.
[38] Forth J, Stokes L, Fitzpatrick A, and Grant C, 2012, Employers' Pension Provision Survey 2011. Around 40% of respondents said they didn't know their likely enrolment destination.

possible" and the vast majority do not expect it to take more than six months from understanding the legislation through to registration[39].

109. For those that have already started to implement their plans, introducing an additional requirement on scheme charges should be relatively straightforward, and the Government will make sure it is communicated clearly and simply to all employers – minimizing the familiarisation costs for these firms.

Cost to firms no longer able to use existing provision

110. Based on data from the Employers' Pension Provision Survey 2011 – which asks employers about the types of pension scheme they intended to use for their employees when the workplace pension reforms are implemented - the Department estimates that over 110,000 private sector firms will use an existing defined-contribution workplace pension scheme for automatic enrolment.

111. Because the survey did not collect information on scheme charges it is not possible to directly observe how many of these employers would have to set up a new scheme as a result of a charge cap. However, on the basis of the range of charges found in the DWP charges survey, the estimated number of employers who currently intend on using an existing workplace pension but who would have to use a new scheme to fulfil their automatic enrolment obligations as a result of a charge cap is presented in Table 4 below.

112. In estimating these numbers, allowance has been made for those employers who either did not know the charge level their members paid or refused to say.[40] The Department have also taken account of schemes which operate a deferred member penalty - adjusting the number of employers affected, based on how many schemes it anticipates will use this form of charging, and the charge levels it might expect deferred members to pay in such circumstances[41]. This is to reflect the fact employers will not be able to use their scheme for automatic enrolment if any members incur charges above the level of the cap (including if this is on account of a deferred member penalty).

113. As an upper-estimate, the Department have assumed that all schemes with a deferred member penalty have at least some of their members being charged above 1% (i.e. above the level of the cap in either case), and will have to arrange an alternative scheme. In making this extreme assumption, the numbers below also cover the situation where employers are not allowed to use a scheme with deferred member penalties for automatic enrolment (i.e. the option whereby deferred member penalties are banned).

[39] The Pensions Regulator, February 2013, *Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012*

[40] Two alternative assumptions have been made. First, that charges in these schemes follow the same distribution as the charges which were reported by employers in Chart 1. Second, that all of these schemes have charges in excess of 1%. Whilst an extreme assumption, it is not unreasonable to suppose that employers who do not know or refuse to say what charges their members pay are particularly susceptible to higher charge levels.

[41] It is assumed that employers will be just as likely to use their scheme for automatic enrolment if it has a deferred member penalty. The Department have then considered how impacts will differ under two scenarios – (i) these schemes have the same distribution of charges as other schemes, but charge deferred members 0.5 percentage points more than active members (the average discount applied according to the 2012 DWP charges survey); and (ii) all of these schemes charge deferred members more than 1%.

Table 4: Number of employers who currently intend on using existing provision, but will no longer be able to under different charge cap levels

	Number of employers affected
0.75%	90,000
1%	25,000 - 35,000

Source: DWP modelling
Notes: Rounded to the nearest 5,000

114. Setting the charge cap at 1% is expected to affect only a relatively small number of employers, because the majority of schemes currently have charges at or below 1%. This reflects the fact many employers currently have a stakeholder pension[42] (and charges on these schemes cannot be more than 1% after 10 years). However, due to the large proportion of schemes charging exactly 1%, setting the cap below this level – at 0.75% - is expected to affect many more employers (albeit with advantage of also reaching many more members).

115. It is possible that the existing schemes which firms intend to use for automatic enrolment will tend to have lower charges on average; the EPP survey found that employers were more likely to say they would retain their current members in their existing scheme if that scheme was larger than the average – and larger schemes tend to have lower charges. This would mean fewer employers would be affected. However, as already indicated, a definition of charges based on a more comprehensive measure than the AMC would be expected to result in more schemes, and thus more employers, being caught by the cap – and therefore higher costs. The Department will be testing this with stakeholders during the consultation.

116. On the basis of these volumes, the estimated cost of setting up alternative provision for these firms is presented in Table 5 below.

117. For employers who would not yet be expected to have started making plans for automatic enrolment, the costs reflect the *additional* activities the Department expects employers will need to perform in setting up a new scheme for automatic enrolment *instead* of using an existing scheme - based on the estimates previously derived from the Department's modelling of administrative costs to employers from automatic enrolment. The approach is set out in Annex G of the Workplace Pension Reform Regulations Impact Assessment[43], and follows the standard cost model methodology recommended by the Better Regulation Executive.

118. For employers who are expected to have already made plans or who have already reached their staging-in date, the costs reflect the *full* range of activities they are expected to perform in setting up a new scheme for automatic enrolment – on the basis they will have to repeat the steps they have already taken in setting up their current qualifying scheme[44].

[42] Forth J, Stokes L, Fitzpatrick A, and Grant C, 2012, Employers' Pension Provision Survey 2011
[43] http://www.dwp.gov.uk/docs/wpr-ia.pdf
[44] It is assumed for the purposes of estimating costs that employers will implement their plans 6 months before their staging date. According to recent research carried out for the Pension Regulator, 70% of medium employers expected it to take no longer than this - around half thought it would take just three months. See The Pensions Regulator, February 2013, *Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012*

119. Employers may be able to mitigate at least some of these costs if they are able to renegotiate the AMC with their pension provider, and continue using their existing scheme. However, in order to avoid under-estimating the potential costs to employers, it is assumed employers do not take this approach.

Table 5: Transitional cost of setting up alternative pension provision – £m (2013/14 prices)

	Cost
0.75% Cap	54 – 55.5
1% Cap	16 – 20.5

Source: DWP modelling
Notes: Rounded to the nearest £0.5 million

120. These costs are transitional only. Once the employer has set up alternative pension provision they will not incur any additional costs – they will not be required to do anything additional, and the Department is not aware of any reason to suspect that the costs associated with administering their new scheme will be any greater. As a result, there are no additional costs from 2018 onwards - as by this time all existing employers who intend on using existing provision will have reached their staging-in date for automatic enrolment.

Impact on smaller employers

121. Given that fewer small employers intend on using their existing scheme for automatic enrolment – and are less likely to have existing pension provision in the first place – it may be reasonable to conclude that they will be proportionately less affected by a charge cap than larger employers.

122. On the other hand, smaller employers may be more likely to be affected because they tend to have smaller schemes and - as previously indicated - smaller schemes tend to have higher charges. The 2011 EPP survey found that the four-fifths of occupational schemes with fewer than 20 active members were located in organisations which themselves had fewer than 20 employees.

123. Unfortunately, due to low sample sizes it is not possible from the available data to break the distribution of charges (Chart 2) down by scheme size. As a result, the Department is also currently unable to break the estimated costs down in Table 4 by employer size.

124. Nonetheless, because the vast majority of employers are small, it remains the case that the majority of employers affected by a charge cap will be small and micro businesses – for example, the Department estimates that 92% of employers planning to use an existing scheme will have fewer than 100 employees. Therefore, even if the schemes used by smaller employers are no more likely to have charges above the level of the cap (which seems unlikely given the evidence), they will still represent the vast majority of firms who need to find alternative provision.

125. It is necessary to extend the charge cap to smaller employers however, as otherwise many schemes with high charges would fall out of scope, and the rationale for the policy would be undermined. By setting up a low-cost pension scheme in the form of NEST, the Government have minimized the cost which these employers will incur in having to find

alternative pension provision for their employees. Other easements for smaller employers should also manage these additional costs, including the fact they won't have to enrol their workers until June 2015 at the earliest (for those with fewer than 50 employees)[45].

IMPACT ON THE PENSION INDUSTRY AND SUPPLY OF PENSION PROVISION

126. Placing a requirement on employers to choose a scheme with a default fund which has charges below a specified level will have an indirect impact on the pensions industry, by reducing demand for schemes with higher charges and increasing demand for schemes with lower charges. Whilst some providers will benefit at the expense of others, there should not be any reduction in the pension industries' overall business (demand), because employers will still be required to enrol their employees into pension schemes[46].

127. Providers offering schemes above the charge level could cease providing certain schemes to certain employers where it is unprofitable to do so with charges at or below the cap level. Alternatively, they could look to bring high annual management charges down. In that case, they may in turn seek to either reduce costs by altering or reducing product features and lowering the quality of pension provision on offer, or by increasing charges elsewhere.

128. The classic economic response to a price ceiling is for service providers to reduce supply. In practice, the Department would expect some pension providers to stop offering schemes to certain employers – in particular, smaller employers who are more costly to provide for and who are not profitable at charges below the level of the cap. Any supply gap should however be filled by other schemes – in particular multi-employer schemes, who are able to offer lower charges by taking advantage of the (administrative and investment) economies of scale available in pension provision[47]. As a minimum, NEST has a public obligation to accept all employers that want to use it as a pension scheme to fulfil their duties under the Pensions Act 2008 – but there are also a number of other schemes which have been set up to offer smaller employers an alternative low-charge scheme to NEST. The consequence will be a transfer of business away from some providers and towards others – namely, providers with larger multi-employer schemes.

129. This will result in a more consolidated industry, with fewer schemes operating at scale. There is reason however to suspect that this consolidation will happen primarily at the scheme rather than provider level - i.e. fewer schemes provided by a similar number of pension providers. At the provider level, the market is already very concentrated, with a relatively small number of organisations dominating the market – statistics released by the ABI in 2010 found that five companies accounted for two-thirds of all insurer-administered

[45] The Pensions Regulator, February 2013, *Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012*

[46] In fact employees may respond to lower charges by contributing more money – although there is little evidence to indicate that contributions are particularly responsive to scheme charges and that there will be such a behavioural response to any meaningful degree.

[47] For example, work carried out by Charles River Associates for the Department for Work and Pensions in 2009 found economies of scale in setting up a scheme, given the fixed costs involved. Whilst the cost for scheme set up was found to increase with size of employer, if calculated on a cost per employees basis, the costs fell as size of firm increased. There was also a slight decline in the set-up costs per individual as the firm size increased.
http://webarchive.nationalarchives.gov.uk/20130314010347/http://research.dwp.gov.uk/asd/asd5/WP74.pdf

pension funds[48]. Furthermore, those who choose to stop offering schemes to smaller employers will still be able to provide schemes to larger, more profitable employers.

130. In some cases, pension providers may choose to continue offering schemes to these employers at a lower charge. However, this would only be the case where it is profitable to do so. That might be the case if the increase in scheme membership generated by automatic enrolment increases the amount of money being contributed to the scheme, and therefore its profitability.

131. Alternatively, providers could look to lower charges (i.e. within the cap) by also lowering the cost of provision. One approach would be to set up a master-trust scheme like other providers have done, to generate economies of scale and to allow the higher revenues from more profitable employers to offset the costs of less profitable members.

132. However, previous analysis has found that the costs of setting up and running master-trusts can be considerable - £2-20 million to adapt existing systems, and £100 million to set up a new system entirely[49] - and as these costs would need to be recouped via member charges, it is not clear that many providers would find it a cost effective option. Because these schemes operate on scale, and the pool of employers is likely to remain relatively fixed, there is also likely to be a limit to the number of master-trust schemes which could be in operation. New master-trust schemes entering the market would end up attracting business away from existing ones, upsetting the balance enabling low charges in the market.

133. Providers could instead reduce costs in single-employer schemes by offering a more basic service in terms of administration, governance, or investment management. In the area of investment management, providers could look to make greater use of passive investment management, to keep costs and governance low, and away from active fund management which can drive charges up – adding an estimated 0.3% to overall cost levels[50].

134. The scope for doing this will be limited by the fact passive management of default funds is already quite common in the UK – according to one study, the 2013 Towers Watson FTSE 100 defined-contribution pension scheme survey, 62% of trust-based schemes and 88% of contract-based schemes used passive management in their default fund. The NAPF 2012 Annual survey meanwhile found that 42% of respondents that used a default fund as part of their scheme offer used a passive tracker approach. Research also suggests that the UK makes much greater use of passive funds than other countries, such as the US.[51]

135. Meanwhile, previous analysis into the default funds in stakeholder pension plans not long after they were introduced, found that many were actively managed: the authors found

[48] https://www.abi.org.uk/Insurance-and-savings/Industry-data/~/media/0131EC5ECD4F4ECCA9F2E154C9C55314.ashx

[49] Johnson P, Yeandle D, and Boulding A, October 2010, *Making Automatic Enrolment Work*, page 86. (Cost estimates from Deloitte research cited in report).

[50] Ashcroft J, 2009, *Defined-Contribution (DC) Arrangements in Anglo-Saxon Countries*, OECD Working Papers on Insurance and Private Pensions, No. 35, OECD http://www.oecd.org/insurance/private-pensions/42601249.pdf

[51] Ashcroft J, 2009, *Defined-Contribution (DC) Arrangements in Anglo-Saxon Countries*, OECD Working Papers on Insurance and Private Pensions, No. 35, OECD http://www.oecd.org/insurance/private-pensions/42601249.pdf and Spence Johnson, November 2011, *The prodigious use of passive funds in UK DC: A new perspective* http://www.dcif.co.uk/resources/DCIF+Passive+funds+in+UK+DC+FINAL+111125.pdf

that a narrow majority (19 of the 35 stakeholder plans considered) were of a 'balanced managed' type fund, and most of these were actively managed[52].

136. Nonetheless, smaller schemes – whose charges are generally higher and who may be most affected by a cap – appear to make less use of passive management. Estimates by Spence Johnson suggest that passive funds make up 69% of assets in DC schemes with more than 5,000 members, whereas smaller schemes have only around a third of assets in passive funds[53]. This implies that even if providers do not directly move to greater use of passive management, a consolidation of pension schemes could have the same effect of moving people into passively managed funds.

137. More generally, the Government would be able to constrain the ability of pension providers to offset the reduction in charges by cutting back on levels of administration and governance, by using its provision in the current Pensions Bill to set minimum quality standards on schemes.

138. Instead, some providers may respond to a charge cap by increasing charges elsewhere - for example, by increasing charges not covered by the cap (although this will be constrained if the cap is sufficiently comprehensive in the charges it captures), or by increasing ("levelling up") the charges which it offers to new business - where these are below the level of the cap. This could either be as they seek to recoup the revenue they lose by having to reduce charges, or because the level of the cap becomes the 'norm'.

139. The scope for this may also be limited however. As the Minister for Pensions indicated to the Work and Pensions Select Committee in January this year, there has been fierce competition amongst pension providers to provide schemes for the larger employers who were staged into automatic enrolment first. Perhaps most importantly, if providers could easily increase their charges on more competitively priced schemes, it would be reasonable to suspect that they would have already done so.

140. The Department will be exploring the likely responses of the pensions industry during its consultation but, given the information currently available, envisages that its main response to a charge cap would be to withdraw schemes for certain types of employers: most providers set their charges on a bespoke basis, considering each employer on a case-by-case basis and negotiating a charge level at which the provider can deliver the scheme profitably, given the level and persistency of contributions. However the Department is also aware a few providers are planning on reviewing and bringing down their charges on legacy schemes.

141. The approach that providers take will have an effect on the likely outcomes individuals might expect from a charge cap. This is considered below.

[52] Byrne A, Blake D, Cairns A, and Dowd K, 2006, *An Analysis of Default Funds in UK Defined Contribution Pension Plans*, Centre for Risk and Insurance Studies http://www.nottingham.ac.uk/business/forum/documents/cris-reports/cris-paper-2006-8.pdf;

[53] Spence Johnson, November 2011, *The prodigious use of passive funds in UK DC: A new perspective* http://www.dcif.co.uk/resources/DCIF+Passive+funds+in+UK+DC+FINAL+111125.pdf

Impact of a charge cap on the solvency of insurers

142. Discussions with the pensions industry and the Prudential Regulation Authority (PRA) have highlighted the fact that introducing a charge cap would have implications for the level of capital insurers are required to hold in order to protect customers against the risk of insolvency.

143. The risks to an insurer's solvency posed by a cap are two-fold: firstly there is a risk that if expenses rise far enough then the lack of an ability to pass this on to consumers by raising the product's price may adversely affect the insurer's solvency; secondly, where the charge is levied on assets under management, its absolute level will vary depending on the performance of the underlying assets and there is a risk that it may not cover expenses. In order to protect against these risks, insurers would have to hold additional capital against the funds covered by the charge cap.

144. This additional capital would come from the insurance company's shareholders and would therefore have a cost, which would be the difference between the expected return on shareholder capital and the yield on risk-free assets (since this is what the additional capital would be held in).

145. This cost is highly uncertain for a number of reasons:
    a. The additional capital required will depend on the amount of assets covered by the cap;
    b. The expected return on shareholder capital will vary by company;
    c. The risk-free yield will vary according to conditions in the market for high quality government bonds.

146. Our current assessment is that the impact will be negligible in the short to medium term because the policy intention is to only apply the cap to schemes that are being used for automatic enrolment, and it will take time for assets under management to build up in new schemes. The majority of the effect will come from older schemes that are being made compliant with the cap and continue to be used for automatic enrolment - a highly uncertain number.

147. The Department is currently unable to quantify this impact because of the lack of publicly available information with which to do so, as well as the significant uncertainty discussed above. However the Department will use the consultation to gather further evidence in this area.

BENEFITS AND RISKS TO INDIVIDUALS

148. Setting a ceiling on the charges which individuals are able to incur in workplace pension schemes could benefit a large number of individuals, by reducing the charges that are deducted from their savings. As previously shown, depending on the level of the cap and the level of the charges they would have incurred otherwise, individuals could receive a large boost in the income they receive in retirement.

149. Based on the example considered previously (in Chart 1), the Department estimates that an individual who saves into a private pension throughout their working life could –

everything else being equal – receive over £400 more a year[54] if they saved into a scheme with a 1% AMC compared to one with a 1.25% AMC[55]. This rises to over £900 a year more if they save into a scheme with a 0.75% AMC.

150. Table 6 presents the Department's estimates of the number of active members of pension schemes who could benefit from lower charges under the following charge caps. The estimates apply the average number of members in existing schemes, using the Employer Pensions Provision survey 2011, to the number of existing schemes that the Department expects to be affected by a charge cap (Table 4 above).

Table 6: Estimated number of individuals who could benefit from lower charges as a result of a charge cap (millions):

	Number of individuals affected
0.75%	1.5
1%	0.25 – 0.35

Source: DWP modelling
Notes: Rounded to the nearest 0.5m.

151. Table 6 under-estimates the overall number of individuals who could potentially benefit in a number of ways. Due to data limitations it is not possible to estimate the number of deferred members in these schemes who will also benefit from the cap. It also does not take into account the fact that the number of active members in these schemes should grow over time as employees not currently saving into a workplace scheme are automatically enrolled[56].

152. Furthermore, as well as affecting existing schemes which employers intend to use for automatic enrolment, a charge cap will also affect some new schemes set up for automatic enrolment – because some of these new schemes may otherwise have charges in excess of the cap.

153. The extent to which the cap affects new schemes depends on the extent to which employers currently without pension provision (particularly smaller employers) enrol their workforce into one of the large multi-employer schemes set up for automatic enrolment, and how charges in other employer schemes evolve under automatic enrolment. As explained above, many employers without provision are expected to use NEST, and even if they don't, it is expected that its low charge structure will provide competitive pressure on other schemes and keep their charges low. The risk remains however that some new smaller schemes set up for automatic enrolment would otherwise continue to charge their members above the level of the cap.

154. Even so, only a small proportion of individuals saving into a workplace pension scheme would be expected to benefit from a charge cap, particularly at the higher charge cap level of 1%. This is because – on the basis of the data available - the majority of schemes

[54] In 2013 earnings terms
[55] Income is expressed in 2013 earnings terms, and calculations based on the assumptions outlined in Chart 1
[56] This depends on the proportion of the workforce not currently contributing to the employers' scheme, their opt-out rate, and the employers' choice of scheme for current non-members – according to the latest Employers Pension Provision Survey the proportion of employers which said they would use existing provision for non-members and new employees was lower than the proportion who said they would use it for existing members.

already charge below the cap, and most schemes affected by the cap are expected to be small (i.e. have a low number of members). Nonetheless, even with a charge cap of 1%, several hundred thousand individuals could potentially see lower charges. By reducing the charges that these individuals incur, the Department could potentially make a valuable contribution to helping them achieve an adequate income in retirement.

155. Notwithstanding the benefit of lower charges, there are risks for individuals in schemes directly affected by the charge cap, as well as those in other schemes not directly affected by it.

156. A cap on prices would usually be expected to result in some individuals being made worse off, as they are unable to gain access to services or products which they otherwise like to – because providers are unable to make a profit and withdraw from the market.

157. However, as previously indicated the Department does not expect a situation to arise whereby individuals will be unable to access any pension provision at all – at the very least their employer will have the option to enrol them in NEST, and there are a number of other schemes offering charges below the level of the caps considered. Even if the range of providers offering pension provision reduces for some employers, the likelihood that individuals are no longer able to access the scheme they would have preferred to be in is mitigated by the fact they do not choose their workplace pension scheme in the first place.

158. Individuals may even benefit if the market is constrained to a small number of larger-scale, multi-employer schemes. Besides tending to have lower charges, larger schemes also tend to be associated with higher levels of governance activity, more frequent meetings of the trustee board, better information provision, more training support provided to trustees and greater awareness of guidance offered by the Pensions Regulator[57].

159. Nonetheless, there remains a risk that preventing employers from using certain higher-charging schemes will result in some individuals being worse off. The Government recognises that retirement outcomes do not just depend on charges – they also depend on a scheme's investment returns[58]. If higher charging schemes reward individuals with better investment performance, moving to a lower charging scheme may ultimately result in a lower income in retirement.

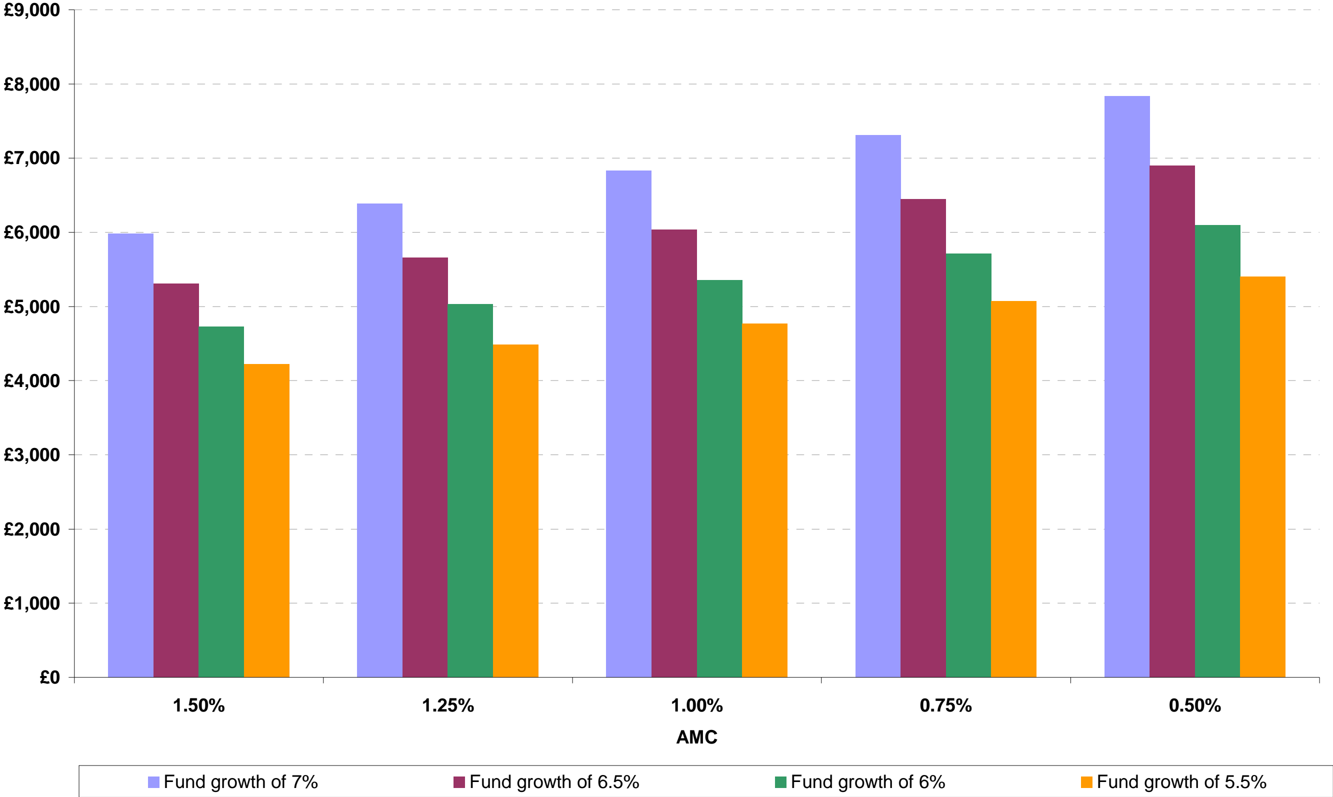
160. Chart 5 presents DWP estimates of the private pension income an individual who saves throughout their working life might receive in their first year of retirement, under different charge and annual fund growth assumptions. Whilst it is apparent that lower charges are generally associated with higher income, this individual would be better off in a scheme which has a 1.25% AMC and achieves nominal investment returns of 7% on average, than in a scheme which has a (lower) 1% AMC and achieves returns of only 6.5%. Their income in retirement would be around £350 a year higher.

161. It is likely that in at least some cases individuals would be better off in a higher-charging scheme (either because this reflects the quality of the scheme or simply because

[57] The Pensions Regulator, 2012, *Occupational pension scheme governance: A report on the 2012 (6th) scheme governance survey*.
[58] The amount the individual and employer contributes will also be a major determinant of retirement income, although it is assumed that scheme choice and scheme charges will not have a major impact on the level of contributions made.

investment returns will inevitably vary to some degree across schemes). However, there is little evidence available to show that it will be the case generally.

Chart 5: Impact of Annual Management Charges and fund growth on annual private pension income (£ expressed in 2013 earnings terms)



Source: Based on DWP modelling
Assumptions:
1) Individual contributes to scheme every year from age 22 until retirement, aged 68
2) Contributes £1,500 a year, growing at 4% per annum.
3) Fund growth expressed in nominal terms.
4) Annuity rate of 6%. No lump sum taken.
5) Earnings growth of 4% per annum.

162. To the extent that investment performance depends on active versus passive fund management – the evidence that the Department has seen suggests that whilst well governed active strategies do sometimes achieve superior performance, in many cases active management does not add value, once costs are taken into account. One study of default funds found that the net performance of passive equity funds was on average 0.8% better than that for active funds over the last five years[59]. Once the benefit of lower annual management charges are taken into account, it is not clear that overall individuals will be worse off if a charge cap increases the use of passive funds - whether this arises because a charge cap leads to a small number of large schemes which are more likely to use passive management, or because it encourages schemes to adopt greater use of passive management to reduce costs.

[59] Ashcroft J, 2009, *Defined-Contribution (DC) Arrangements in Anglo-Saxon Countries*, OECD Working Papers on Insurance and Private Pensions, No. 35, OECD http://www.oecd.org/insurance/private-pensions/42601249.pdf

163. Because the charge cap would only apply to the default fund in the employers' qualifying scheme, and because most schemes offer a range of fund choices, most individuals will also have the option to opt into an alternative fund if they think it is likely to offer greater fund growth potential.

Levelling up of charges

164. There is also a risk that some individuals will see their charges increase. In particular, where an employer's current scheme operates an active member discount, it is possible that the active members of these schemes will see their AMC increase. The extent of any increase is likely to depend on the size of the discount, and the proportion of members who are active and deferred, as well as the extent to which the higher charge for deferred members is subsidizing a lower active member charge rather than simply boosting profit levels (i.e. the extent to which the difference reflects a "penalty" rather than a "discount")

165. This risk is mitigated by the fact the majority of existing schemes do not operate such differential pricing. Furthermore, it would be reasonable to suspect that many of the active members will eventually become deferred members, and so they will benefit from the charge cap in time.

166. There is a risk that individuals in schemes not directly affected by the charge cap may also see their charge increase, if providers level up their charges in these schemes. This may arise if the cap becomes the "norm", or if providers seek to recoup lost revenue.

167. The risk of this should be low if the charge cap is set at 1%, because the stakeholder charge cap - currently at 1% after 10 years - already provides a benchmark for schemes to tend towards (possibly offering some explanation for why a third of trust- and contract-based schemes currently have charges at this level). Furthermore, at 1% there will be less pressure on providers to recoup lost revenue given that the minority of schemes charge above this level.

168. The pressure may increase if the charge cap is set at 0.75%, although even in this case, NEST and the other multi-employer schemes with charges equivalent to a 0.5% AMC could act as an alternative lower benchmark to counteract this levelling up risk

Overall Net Present Value (NPV) of a charge cap

169. A charge cap has the potential to benefit large numbers of individuals by increasing the value of their pension savings and their income in retirement through a reduction in charges. The net benefit will depend on whether and how far the reduction in charges is associated with lower fund growth. To assess this, the Department would welcome further evidence from stakeholders on the relationship between the level of the AMC and investment growth.

170. The overall net present value will vary according to how the industry responds to the charge cap, and in particular the extent to which the net benefit to individuals directly affected by the cap is offset by any loss incurred by pension providers, or by other individuals who see higher charges than they otherwise would.

171. At the extreme, these losses could completely offset the benefit to individuals (although in this case, the charge cap would still achieve the Government's objective of protecting those individuals who incur, or are at risk of incurring excessively high charges). On the other hand, if the reduction in charges is associated with a consolidation of schemes, the benefit to individuals could be achieved through a more efficient market, with little overall loss to the industry – through a smaller number of larger, more efficient schemes which benefit from economies of scale, and which keep charges low for other individuals.

172. The Department will provide an estimate of the overall net present value in a revised Impact Assessment following consultation, once it is better able to gauge the response of the industry, and potential scale of losses incurred by providers and other individuals - along with any further evidence on the link between annual management charges and investment growth.

173. Notwithstanding this, based on the evidence currently available, a charge cap may be the only reliable way of achieving the Department's objective of ensuring individuals do not see the value of their pensions eroded by high charges.

Direct cost to business of preferred option

174. A charge cap on the default fund of qualifying schemes would impose a direct cost on employers – from having to set up new pension provision where the charges in their existing scheme exceed the level of the cap.

175. This represents a transitional cost only. Once the employer has set up new pension provision, there will be no additional requirements placed upon them, and there is little reason to suspect that the ongoing costs associated with administering the new scheme should be greater than that for their original (higher-charging) scheme.

176. As a result, the equivalent annual net cost to business of the Government's preferred option, over the default period of 10 years recommended in the Better Regulation Framework Manual,[60] is estimated to be £1.9m with a charge cap of 1% and £5m with a charge cap of 0.75%.

[60] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf