



Department  
for Work &  
Pensions

# The charge cap: guidance for trustees and managers of occupational schemes

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# Introduction

## About this guidance

1. This guidance relates to the Occupational Pension Schemes (Charges and Governance) Regulations 2015<sup>1</sup> ('the Regulations') which take effect on 6 April 2015. From that date, the default arrangement within certain pension schemes used by employers to meet their automatic enrolment duties ('qualifying schemes') will be subject to a cap on the charges which may be borne by scheme members. The charge cap is 0.75% of funds under management within the default arrangement, or an equivalent combination charge. The cap applies to all scheme and investment administration charges, excluding transaction costs and a small number of other specified costs and charges.
2. This non-statutory guidance provides an overview of how key elements of the Regulations work. Trustees and managers should consider the Regulations to determine whether the new requirements apply to their schemes, taking further advice where necessary.

## Who this guidance applies to

3. This guidance covers the Regulations, which relate to occupational pension schemes only. The Financial Conduct Authority (FCA) has published corresponding rules and a policy statement for providers of workplace personal pension schemes.<sup>2</sup>
4. This guidance on the charge cap is aimed primarily at trustees and managers of relevant occupational pension schemes and their advisers.

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<sup>1</sup> SI 2015/879 (<http://www.legislation.gov.uk/ukxi/2015/879/contents/made>). These Regulations are amended by The Occupational Pension Schemes (Charges and Governance) (Amendment) Regulations 2015 (SI 2015/889) (<http://www.legislation.gov.uk/ukxi/2015/889/contents/made>), which were made on 25 March and also come into force on 6 April 2015.

<sup>2</sup> PS15/4 - Final rules for charges in workplace personal pension schemes and feedback on CP 14/24 - <http://www.fca.org.uk/your-fca/documents/policy-statements/ps15-05>

# What schemes are affected by the cap?

**Key term: “Relevant scheme”**

Occupational pension schemes used by employers as qualifying schemes for automatic enrolment and which provide money purchase benefits, subject to certain exclusions.

5. The charge cap applies to occupational pension schemes, with certain exceptions. It will not apply to schemes which meet one or more of the following conditions:
  - schemes which are not qualifying schemes;
  - schemes which do not offer any money purchase benefits, or which only offer these benefits through Additional Voluntary Contributions;
  - relevant small schemes – see regulation 2 for more information;
  - executive pension schemes – as defined in regulation 2;
  - schemes with only one member.
6. If you are a trustee or manager of an occupational scheme which does not meet any of the exclusions above, the charge cap could apply to some members of your scheme. The sections of this guidance on default arrangements and the application of the cap provide further information.

# Which scheme members will be covered by the cap?

**Key term: “Relevant date” (regulation 3(9))**

This will either be 6 April 2015, when the Regulations come into force, or the employer’s staging date if later.

7. The charge cap will apply to those scheme members who contribute to a default arrangement (explained in more detail later) of a relevant scheme on or after the relevant date. These members are from here on referred to as ‘relevant members’ in this guidance. Trustees and managers will need to ensure that the default arrangement is compliant from the point that they receive the first contribution on or after this date.
8. The charge cap will continue to apply to members’ funds which remain invested in the default arrangement. This will be the case even if the member leaves their employer or stops making contributions and becomes a non-contributing, or ‘deferred’ member.

9. Where a default arrangement is subject to the charge cap, the cap will apply to all the relevant members' funds in that arrangement, including funds that were accumulated before the relevant date.

**Example 1 – members covered by the cap**

In September 2014, Lionel and Marvin are both contributing to Fund J. Marvin moves to a new employer in January 2015 and stops making contributions to his previous employer's pension scheme. At this point, Marvin is automatically enrolled into his new employer's pension scheme without making an active choice.

On 6 April 2015, Fund J is designated as a default arrangement under regulation 3 of the Occupational Pension Schemes (Charges and Governance) Regulations.

As Lionel is still making contributions into Fund J, he is covered by the charge cap. All of the contributions he has made into Fund J will be subject to the cap, including those made before April 2015.

As Marvin stopped making contributions to Fund J before 6 April 2015, his pot will not be covered by the cap. His pot in his new employer's scheme will be capped, however.

# What are the restrictions on charge structures and levels?

10. Under the new requirements, only three types of charging structure may be used in the default arrangements of qualifying schemes. These are subject to different but broadly equivalent charge limits:

- a single percentage charge – capped at 0.75 per cent of funds under management
- a combination of a contribution charge plus a percentage of funds under management charge – permissible combinations are shown in the table below

<b>Contribution percentage charge rate (%)</b>	<b>Percentage of funds under management rate (%)</b>
1 or lower	0.6
Higher than 1 but no higher than 2	0.5
Higher than 2 but no higher than 2.5	0.4

- a combination of a flat fee plus a percentage of funds under management charge – permissible combinations are below

<b>Flat fee charge (£ per year)</b>	<b>Percentage of funds under management rate (%)</b>
10 or less	0.6
More than 10 but no more than 20	0.5
More than 20 but no more than 25	0.4

11. These charge limits apply at member level – that means that each relevant member must not be subject to a charge in excess of the limits above.

## What costs and charges are capped?

12. The charge cap will apply to all costs and charges associated with scheme and investment administration. Charges that are outside the cap include the following:

- Transaction costs – these are the variable costs incurred as a result of the buying, selling, lending and borrowing of investments
- Winding up costs
- The costs of complying with a court order
- Charges associated with pension sharing on divorce orders
- The costs which are solely associated with providing death benefits; and
- Property holding and maintenance costs – the costs incurred as a result of holding or maintaining property. These costs are distinct from buying or selling property as these are transaction costs.

13. We have published a more detailed non-exhaustive list of example transaction costs and charges subject to the cap which trustees and managers may wish to consult.<sup>3</sup>

## How do I identify a default arrangement?

14. The charge cap applies to the default arrangement of relevant schemes. A default can be a single fund, or a group of funds chosen by the trustees or managers to meet a particular investment strategy – for example a lifestyle approach.

<sup>3</sup> See Annex A of 'Government response to the consultation on Better workplace pensions: Putting savers' interests first', published at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/400864/better-workplace-pensions-putting-savers-interests-first-response.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400864/better-workplace-pensions-putting-savers-interests-first-response.pdf). This list does not form part of the regulations.

15. For an arrangement to be designated a default subject to the charge cap, it must provide money purchase benefits<sup>4</sup>, form part of a scheme which is used to meet automatic enrolment duties<sup>5</sup> in relation to at least one jobholder and meet one or more of the following three tests. These are set out in regulations 3(2)(a), (b) and (c). In schemes set up for automatic enrolment, only the first test is likely to apply:

A. Any arrangement into which contributions of the employer's workers are directed without them having made a choice (a true default)

– this is the commonly understood definition of a default.

B. Any arrangement to which at least 80%\* of the employer's workers who are active members are contributing on the relevant date (the 80% one-off test)

– this is a one-off assessment on the relevant date, primarily designed to capture workers who joined a scheme before automatic enrolment, which is now being used as a qualifying scheme.

C. Any arrangement which first receives contributions after the relevant date and to which at least 80%\* of the employer's workers who are active members are contributing (the 80% ongoing test)

– this is an on-going assessment, designed to ensure that workers who are enrolled into a scheme by contract joining prior to starting employment, and are required to make a choice about where their contributions are invested, are protected by the cap. As this situation is likely to be rare, we expect very few arrangements to be caught by this test.

\* Only contributing members who were required to make a choice as to the arrangement in which their contributions were invested should be counted in each of these calculations. Members within the scheme who are only accruing non-money purchase benefits, or who are only making AVCs should not be included.

16. In addition, there are five further points to bear in mind:

- **Schemes which are used by more than one employer will need to check the default for each employer.** An arrangement which is a default for one employer will not necessarily be a default for another and different employers can have different default arrangements.
- **The charge cap does not apply to arrangements which contain promises.** As well as non-money purchase benefits being exempt from the cap, this

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<sup>4</sup> This is defined in sections 181 and 181B of the Pension Schemes Act 1993, as amended by section 29 of the Pensions Act 2011. This legislation can be found here:

<http://lawvolumes.dwp.gov.uk/docs/a5-1251.pdf>

<sup>5</sup> Regulation 3(1)(a) specifies that the arrangement must be used by a qualifying scheme in relation to at least one jobholder.

means that arrangements that include a third party promise<sup>6</sup> are not subject to the cap. For example, where an occupational scheme purchases a fund with a guaranteed investment return from an insurer it may meet the description of a third party promise.

- **The charge cap does not apply to arrangements which are only receiving Additional Voluntary Contributions.** This means that even where a member does not express a choice of the arrangement to which their AVCs are allocated (so the arrangement meets test A above) it is still not designated as a default<sup>7</sup>.
- **Once an arrangement has been identified as a default subject to the cap, it will remain a default subject to the cap.** If the employer starts enrolling new joiners into a new default, the funds invested in the old default will still be protected by the cap.
- **Where an arrangement is designated as a default, it is a default for that employer.** So if another worker actively chooses a fund which is being used as a default for their colleague, they will also be protected by the cap. This ensures that members of the same scheme in the same organisation, enrolled in the same arrangement, should be protected by the charge cap.

17. Figure 1 over page summarises the overall default designation process. Further details of the individual tests and accompanying examples then follow.

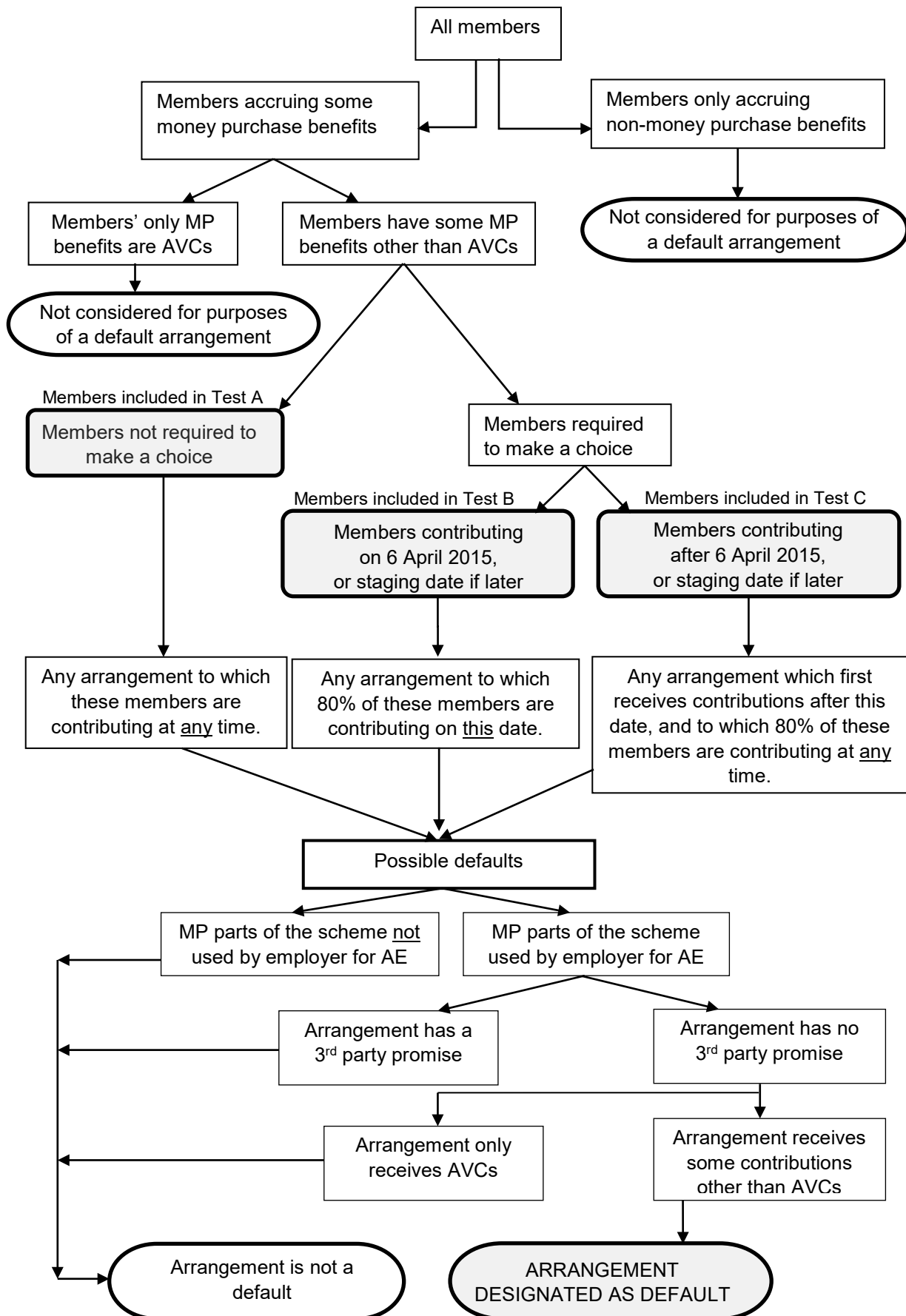
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<sup>6</sup> The term 'promise' is intended to have its everyday meaning. The Pension Schemes Act 2015 uses this terminology and the Act's accompanying Explanatory Notes provide further information on this. Trustees may wish to seek legal advice on whether a guarantee constitutes a promise.

<sup>7</sup> As set out in The Occupational Pension Schemes (Charges and Governance) (Amendment) Regulations 2015 (SI 2015/889) <http://www.legislation.gov.uk/uksi/2015/889/contents/made>.



**Figure 1 - Default Arrangement end-to-end process**



## Test A – ‘true’ defaults

### Example 2 – identifying default arrangements

Maed-Upp Ltd reached their automatic enrolment staging date in 2012. They had not previously offered an occupational pension. They automatically enrolled existing and new staff into the GONK master trust, with the Balanced Managed fund initially being used as the default for any worker who did not express a choice as to where their contributions would be invested.

Anita and Barry were automatically enrolled into the scheme, and defaulted into the Balanced Managed fund. Carl was also automatically enrolled into the scheme, but actively chose to invest instead in the Target Date Fund 1.

In 2013, new workers of Maed-Upp who did not make a choice (including new member Donna) were automatically enrolled into the Target Date Fund 1. However, they left existing members (including Anita and Barry) to continue to contribute to the Balanced Managed fund.

From late 2014, new workers (including new member Edwin) were automatically enrolled into the Target Date Fund 2. They also offered existing workers the opportunity to divert future contributions from one of the old defaults into this new fund. Anita chose to divert her new contributions to Target Date Fund 2. Barry, Carl and Donna continued to contribute to their existing funds.

In April 2015, the default fund charge cap came into effect. At various times, Maed-Upp had used three different funds. In April 2015 each of these still had some members with whom the employer was continuing to meet their automatic enrolment duties.

In addition, each fund meets test A outlined above in paragraph 15 (regulation 3(2)(a)), because they are receiving contributions without the member making an active choice as to where their funds are directed – Barry is contributing to the Balanced Managed Fund; Donna is contributing to Target Date Fund 1; and Edwin is contributing to Target Date Fund 2. Therefore all three of the funds are designated as default funds.

Because a default is a default for all workers of the same employer, Anita and Carl, who both actively chose to contribute to one of the three default arrangements, are also protected by the cap.

Even if Donna transferred out of Target Date Fund 1 Carl would continue to be protected by the cap. Likewise if Edwin transferred out of Target Date Fund 2, Anita would continue to be protected by the cap.

18. Just because an arrangement is being used as a default for one employer in a multi-employer scheme, it does not mean that it is automatically a default for other employers using the scheme. The test for defaults will need to be checked for each employer.

### **Example 3 – default arrangements and different employers**

Like Maed-Upp Ltd, Vikstushas had not previously offered a pension scheme. They staged in 2012 and automatically enrolled existing staff and all future staff in the GONK Master Trust Target Date Fund 2. They did not subsequently change the default.

Gladys joined in March 2015 and actively chose the Balanced Managed Fund.

Both arrangements are being used to meet the employer's automatic enrolment duties but only Target Date Fund 2 is a default as members were not required to make a choice as to where their contributions were directed, but Gladys did decide to express a choice.

This means that Balanced Managed Fund is a default fund for workers of Maed-Upp but not for Vikstushas.

## **Test B – the one-off 80% test**

19. Where employers have offered an occupational pension scheme prior to automatic enrolment, it is likely that some members will have been required to make a choice as to where their funds were directed. Where this is the case, trustees should carry out separate exercises to identify the default for those members who were required to make an active choice and those who were not required to do so.
20. Test B is only needed for those members who were required to make an active choice. The test is again carried out at employer level. Trustees should have records which indicate the funds into which members' contributions are being allocated, when members joined the scheme<sup>8</sup>, and whether at the time the trustees required members to make an active choice.
21. The 80% test should be carried out by reference to the position on the relevant date (6 April 2015, or the employer's staging date, if later). Any arrangement which has at least 80% of those members who were required to make an active choice invested in it, will be identified as a default. There is value in analysing the distribution of members across different funds in the run-up to this date, to assess the likelihood of particular arrangements reaching the 80% threshold.

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<sup>8</sup> This is a common data item, as set out in The Pensions Regulator's 2010 record keeping guidance and referenced in TPR's Code of practice no. 13, Governance and administration of occupational defined contribution trust-based pension schemes, available here:  
<http://www.thepensionsregulator.gov.uk/docs/code-13.pdf>

#### **Example 4 – carrying out the 80% test**

Until the end of 2009, the trustees of Pre-Tend plc's scheme required members to make an active choice of where their contributions would be directed. From 1 January 2010, they stopped requiring new joiners to make an active choice and instead enrolled them into a Lifestyle Strategy.

When Pre-Tend reached their automatic enrolment staging date in 2014, new joiners were automatically enrolled into the Lifestyle Strategy, and existing staff who had not previously joined the pension scheme were automatically enrolled into this arrangement too. The Lifestyle Strategy would therefore be a default as a result of meeting test A, above.

In the run-up to April 2015, the trustees carried out an analysis of their membership and the default. First they stripped out of the analysis any members who joined on or after 1 January 2010 - the date on which they no longer required members to make an active choice.

In the run up to April 2015, trustees found they had 100 members actively contributing who were required to make an active choice when they joined the scheme. 60 of these were contributing to arrangement W, whilst the remaining 40 were spread across arrangements X, Y and Z.

As only 60% of this group of members were invested in a single arrangement, the trustees of the Pre-Tend scheme concluded it was unlikely that either arrangement W would be identified as a default when the charge cap came into effect, but agreed to monitor the situation. By 6 April 2015, the number of active members who were required to make an active choice had fallen to 95 of whom 58 were invested in arrangement W. This meant that arrangement W now accounted for 61% of members.

This means that the only default arrangement in the Pre-Tend scheme is the Lifestyle Strategy.

22. Where a scheme offers a mix of money purchase and non-money purchase benefits, this will affect the calculation. As explained above, the 80% test should only include members who were required to make an active choice, and who are accruing some money purchase benefits other than through AVCs.

### Example 5 – the 80% test and non-money purchase benefits

Until 2003, U N Reel & Sons offered a final salary pension arrangement DB1 to all staff. At this point, the final salary arrangement was closed to new joiners, who were instead enrolled in the same scheme with a range of money purchase investment options. A few existing staff chose to make money purchase AVCs and were required to choose from the same range of money purchase investment options as new joiners.

Later in 2008 U N Reel asked their trustees to create a diversified ‘default’ arrangement (DA1). However new joiners were still required to make an active choice, and were also offered other investment options.

When U N Reel staged in June 2013 they automatically enrolled new and existing staff into a different arrangement - DA2. DA2 will be designated as a default because it meets default test A outlined above.

In the run up to April 2015, the trustees analysed the distribution of contributing members as follows:

150 members in DB scheme		100 members All MP - Joined pre-AE – required to make choice		200 members All MP - Joined post-AE – no choice
120 members all non-MP ↓	30 members all non-MP except AVCs ↓	82 invested in DA1	18 in other funds	↓
EXCLUDED (reg 2(2))	EXCLUDED (reg 2(2) and 3(9))			EXCLUDED – not part of Test B

Therefore only the 100 members who were required to make an active choice and were accruing money purchase benefits other than through AVCs are included in the test. Because 82 out of 100 of these are contributing to DA1, this arrangement will meet the 80% test and be designated as a default.

## Test C – the on-going 80% test

23. This test has been designed to cater for a specific situation where scheme members are required to make an active choice as to where their contributions are invested after the relevant date. This would be the case where an employer contract-joins new workers before they become jobholders eligible to be automatically enrolled, and requires them to choose a fund at that point.

24. In most cases, test C will not apply because employers will automatically enrol new staff into a scheme without requiring them to make an active choice about where their contributions are invested.

25. Where test C is applicable, the Regulations set out that where an arrangement first receives contributions from workers of the employer after the relevant date, and at any point thereafter 80% or more of contributing workers of that employer who were required to make a choice are contributing to that arrangement, then it will be designated as a default arrangement.

26. Where trustees have concerns about needing to monitor the distribution of members across arrangements, they should instead consider providing a ‘true’ default to new joiners, so that they do not need to make a choice of where their contributions are invested.

**Example 6 – contract joining**

The N Vented Partnership have historically contract-joined all new staff who do not make an active choice not to join their occupational pension scheme.

With the advent of automatic enrolment they continued to enrol new joiners in this way, and continued to require members to make a choice between 4 arrangements.

On 6 April 2015, members were distributed as follows:

<u>Arrangement</u>	<u>Contributing members</u>	<u>% of active members</u>
A	30	15%
B	70	35%
C	70	35%
D	30	15%

As no arrangement is receiving contributions from more than 80% of the active members, none of the arrangements are designated as a default under test B above (see paragraph 15).

Shortly after the Regulations came into force, the trustees of N Vented’s scheme decided to introduce a new arrangement E. The trustees would be required to continue to monitor the percentage of members contributing to arrangement E. Many new joiners joined this arrangement, and some existing members also diverted their contributions to it.

By April 2020, members were distributed as follows:

<u>Arrangement</u>	<u>Contributing members</u>	<u>% of active members</u>
All other arrangements	100	20%
E	400	80%

At this point, arrangement E would become a default. Through regulation 4(2), any contribution made by or on behalf of a member after the date on which it is designated as a default will result in that member being protected by the cap.

## What if a fund cannot be offered below the charge cap?

27. Once trustees have identified the arrangements in their scheme(s) that are likely to be subject to the charge cap, they should consider the level of charges in these arrangements and how to ensure they comply with the cap.

28. There may be situations where in advance of the relevant date trustees can see that an arrangement is going to become subject to the charge cap, but which they feel they cannot offer within the cap<sup>9</sup>. Here, they have two primary options:

- **Close the arrangement** to future contributions by all workers of the employer, ahead of the relevant date. Alternatively where the arrangement is only at risk of being designated a default under test B, they may wish to close the arrangement only to new workers of the employer to reduce this risk
- **Move the contributing members** by re-directing future contributions to a new charge cap compliant default in advance of the relevant date (they may also choose to move accrued funds to the new default).

In doing this, trustees may allow members to opt-out of the transfer if they actively wish to continue contributing to the original, un-capped arrangement. Where members were originally required to make a choice as to where to invest their contributions, there are requirements relating to the form that this agreement may take. These are set out in regulation 3(4) and include that the agreement must be in writing (which includes certain digital formats, such as email<sup>10</sup>).

If the trustees choose instead to ask members to opt-in to diverting their contributions to a new arrangement (rather than diverting their contributions unless they opt-out), the old arrangement could be designated as a default, either because some members continue contributing without having made an active choice (in which case it would meet test A) or because 80% of the members who were required to make an active choice are still contributing to it (in which case it would meet test B).

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<sup>9</sup> For the case where trustees identify after the relevant date that they may have difficulties complying with the cap, they may be able to use the adjustment measure, described in regulation 10.

<sup>10</sup> See the definition of "writing" in regulation 2.

### **Example 7 – opting in and the default arrangement**

Isaac joined U N Reel & Sons (see Example 5) in 2010. He was required to make an active choice and opted to contribute to DA1.

James and Kim both joined UN Reel & Sons after the staging date in 2013. They were automatically enrolled in DA2 without making a choice as to where their contributions were directed.

For the purposes of this example, DA1 and DA2 are both set to meet the criteria to be designated as default arrangements in April 2015 (under tests B and A respectively), but charges in both exceed the cap.

The trustees decide to allow members the option to continue to contribute to DA1 and DA2 and open DA3 as a new default, which will be subject to the charge cap.

They write to all active members of DA1 and DA2 who are employed by U N Reel & Sons to tell them that their contributions will be redirected to DA3 in March 2015 if they take no further action. The letter also explains that they may actively choose to stay in DA1 and DA2 (and outlines the process to do so) but indicates that these funds will not be subject to the charge cap.

Isaac actively chooses to stay in DA1. James actively chooses to continue to contribute to DA2, whilst Kim takes no action and her future contributions are diverted to DA3.

From April 2015, the default arrangement charge cap applies to DA3 because workers' contributions are being directed into this fund by default. It does not apply to DA1 or DA2. Therefore Kim will be subject to the cap, while James and Isaac are not.

## **How can I assess the charges borne by members?**

### **Background**

29. The remainder of this guidance covers the two methods by which trustees and managers may measure charges to ensure they are compliant with the cap.
30. This guidance explains in detail how trustees and managers may calculate the maximum permitted level of charges. It is not our expectation, however, that trustees will need to carry out individual-level calculations or reporting on a member-by-member basis. Trustees will instead need to ensure sufficient levels of monitoring and controls to provide certainty that the cap is not exceeded for any member.
31. The extent of monitoring and controls of charge levels which will be necessary will depend to a large degree on how close the charges are to the 0.75% cap (or equivalent combination charge). For example, where trustees and managers intend to charge exactly 0.75%, this will give no margin of safety in the event of



unexpected charges, or aspects of their scheme's charges regime which result in some members being faced with higher charges due to their joining or leaving date. A scheme which aims to charge only an annual funds under management charge of say 0.50% will have considerably more latitude in complying with the charge cap.

32. The examples of charge assessment below, as well as the underlying assumptions, are for illustration only. There is no requirement for trustees or managers to use similar assumptions, and neither the prospective or retrospective methods rely on any assumptions about underlying growth rate, fluctuations, contribution rates, funds under management, or the specific details of any charging regime. The information below is therefore only provided for information. Further details on the underlying assumptions is provided in paragraphs 78 to 80.

## **The two methods of assessing charges**

33. Trustees and managers may choose from two methods to confirm compliance with the charge cap:

- the prospective method of assessment; and
- the retrospective method of assessment.

34. The two methods have many features in common:

- charge compliance takes place over a charges year;
- the cap is at member level – no member may be charged over 0.75% or an equivalent combination charge;
- the charge limits are the same;
- the maximum charge is pro-rated when the cap applies to a member for less than a full charges year;
- the charge levied on the member is expressed as a percentage of that member's average funds under management, recorded at regularly spaced reference points which may be no more than 3 months apart;
- the actual funds under management at each reference point are averaged;
- charges which have been calculated but not yet deducted are treated as if they are still part of the member's pot;
- where the member is invested for just one reference point in the charges year – for example because they transfer in late in the charges year, or they transfer out early in the charges year - the value at that sole reference point is used (regulation 7(6));
- where the member is invested for no reference points, the fund value at the end of the charges year, or the last day in which the member is invested, is used as the reference point value – see regulation 7(7).

**Key term: “Charges year”**

The charge cap is an annual cap – the charges are measured over a 12 month ‘charges year’. This may be aligned with the scheme year used for other purposes –see regulation 2.

**Key term: “Pro-rating”**

A key concept in both methods of assessment is the concept of pro-rating. This is set out in regulation 2(3) and 2(4).

Where the default fund charge cap applies for only part of the charges year – for example, because the member joins or leaves the default arrangement part way through the charges year, or because the arrangement is designated as a default fund part way through the charges year - the maximum charge which can be levied must be adjusted in proportion to the part of the year for which the cap applies, expressed in days.

For example - a charges year runs from 1 April to 31 March. If the default arrangement charge cap applies to the member from 1 March, the maximum charge which can be imposed on them in that charges year is  $(31/365) \times 0.75\%$ .

When members are only invested for a part-year, pro-rating should be carried out on the basis of the number of days of the charges year in which the member has funds under management whilst the cap applies to the member.

For example, if a member’s funds are first invested in an arrangement on 1 July 2015 and the member last has funds under management on 31 August, the maximum charge is  $(62/365) \times 0.75\%$ .

In leap years, pro-rating should take place using 366 as the denominator.

**Key term: “Reference points”**

Reference points are used to obtain the average value of the fund across the year. They must be set at equal intervals through the charges year, no more than 3 months apart. There is no requirement for the first reference point in the charges year to coincide with the start of the charges year, or for the final reference point to coincide with the end of the charges year.

For the purposes of an equal interval, this may be equal numbers of days or months (see regulation 7(8)).

The following would all be a compliant set of reference points in a charges year running from 1 April to 31 March.

**Quarterly:** (1) 1 Apr, 1 July, 1 Oct, 1 Jan; (2) 31 May, 31 Aug, 30 Nov, 28 Feb;

**Monthly:** 15 Apr, 15 May, 15 June .... 15 Feb, 15 Mar

**Weekly:** 6 Apr, 13 Apr, 20 Apr ... 14 Mar, 21 Mar, 28 Mar

To determine the average funds under management, the fund values at each reference point (“the reference point value”) across the charges year are taken and averaged. Charges as a percentage of this average should not exceed the pro-rated *applicable percentage*.

## Prospective method of assessment

35. For many schemes, the prospective method of assessing charges will be less onerous and is likely to be preferable. We therefore explain this option first.
36. In the prospective method, the trustees or managers in effect certify at the beginning of the charges year that the scheme’s *charges regime* complies with the charge cap.
37. This method will only be suitable for schemes which have a predictable charges regime (regulation 8(4)). As part of this methodology the scheme ignores fluctuations in fund value and member deposits and withdrawals during the charges year (regulation 8(3)(a)).
38. Where a scheme does have a predictable regime it may be easier to confirm charge compliance on this basis. This is because once the trustees have assured themselves that the scheme is compliant, they will not need to continue to monitor the charges deducted, provided they continue to use the same, compliant charging regime.

**Key term: “Charges regime”**

The key concept in the prospective method of assessment is the charges regime. This is defined in regulation 8(4) and consists of:

- the system of percentage charges, and any rebate;
- what the percentage is multiplied by – for example, the funds under management on that day, or the average funds under management over the preceding month;
- when the charges are deducted, or the rebates applied.

Some example charges regimes are:

A daily charge of  $(1/365) \times 0.75\%$  of the member’s funds under management, calculated using the member’s funds under management on that day and deducted the same day.

A daily charge of  $(1/365) \times 0.5\%$  of the member’s funds under management, calculated and deducted in the same way as above, combined with a monthly charge of  $(1/12) \times 0.25\%$  calculated using the member’s funds under management on the final day of the month, and deducted the same day – and pro-rated when the member has less than 1 month’s service.

39. The prospective method of assessment has been created to address the particular issue of schemes which rely on a charging mechanism involving rebates, or invest in a range of blended funds which have different charge levels. However, we would anticipate that most schemes which use any kind of predictable charge regime will generally prefer to use this method.
40. To comply through this method, the trustees will need to verify that discounting any fluctuations in fund value and member deposits and withdrawals through the charges year (regulation 8(3)(a)), the maximum charge under the charging regime to be used would not exceed the cap (regulation 8(2)). Once they have assured themselves that this is the case, they will not need to continue to monitor the charges deducted, provided they continue to use the same, compliant charging regime in the charges year.
41. The prospective method also needs to ensure that, given the joining date (regulation 8(5)) and leaving date (regulation 8(3)(b)) for each individual member, and the funds under management at the earliest point in the charges year in which they are invested, they still comply with the cap.
42. In carrying out this assessment we would generally expect trustees would wish to satisfy themselves that their charges regime complied with the cap by carrying out the assessment for a variety of member scenarios:
  - A member who is invested in the scheme from the start through to the end of the charges year.

- A member who joins part way through the year and is still invested at the end of the charges year.
- A member who is invested in the scheme from the start of the year, but leaves the scheme before the end of the charges year.
- A member who joins part way through the year and leaves before the end of the year.

43. Depending on the precise details of the charges regime, trustees or their advisers may identify particular date ranges, for example those clustered around periods of higher charges, against which they will want to check compliance. Where on closer inspection a breach looks possible, trustees may consider adapting their charges regime to “iron out” any such glitches.

44. Overall, as long as the charges regime has a sufficient degree of repetition (for example, a monthly cycle), then it is likely that trustees will only need to use a few scenarios to satisfy themselves that they can comply with the cap in all circumstances.

## **Retrospective method of assessment**

45. In the retrospective method, the scheme confirms charge compliance when the charge cap ceases to apply to that member in the charges year (for example, because the member leaves, or because the charges year has ended) based on the actual value of funds under management for each individual member (regulations 7(2) and 7(4)).

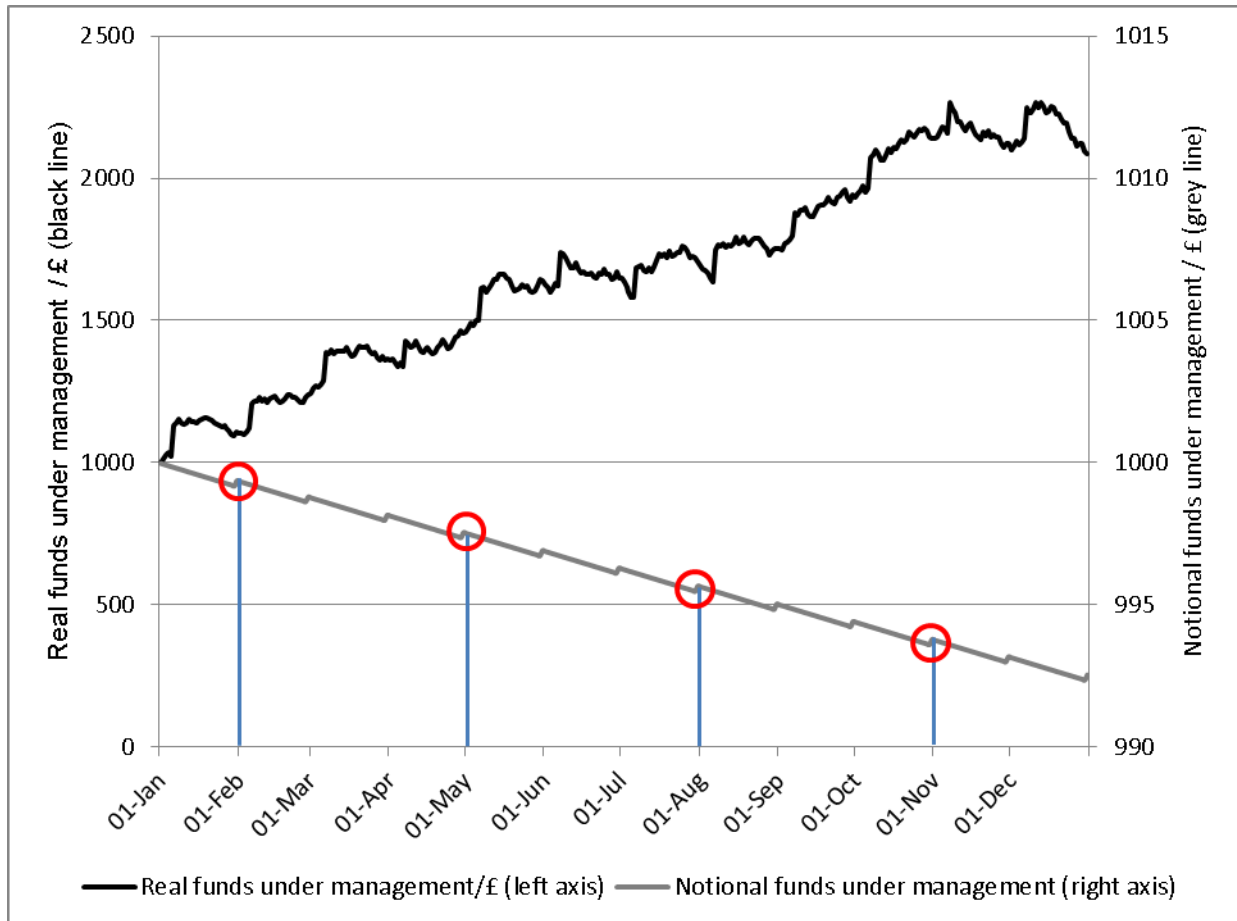
46. Schemes with a less predictable charges regime, or which levy charges on members as and when costs are incurred, may wish to confirm that they are compliant in this way.

## **Assessment examples**

47. The rest of this paper consists of examples of applying the prospective and retrospective methods of charge assessment.

## Prospective method of assessment - examples

### Example 8: Quarterly reference points – member invested for the whole year



48. In example 8 above the member starts the year with £1000 of funds under management, and continues to contribute £100 per month. The charges year runs from 1 January to 31 December, and quarterly reference points are set at 1 February, 1 May, 1 August and 1 November.

49. The black line shows that the member's funds under management fluctuate with the value of the assets, but with an underlying upward trend, due to member contributions and investment growth.

50. Using the prospective method of assessment, the actual funds under management are not used to confirm charge compliance. The charges regime is instead tested in advance. For the purposes of the test it is assumed that the member does not make any contributions or withdrawals and there is no fluctuation in the value of the members' investments. The only change in value is therefore due to the imposition of charges. This is the 'notional' funds under managed represented by the grey line in the chart above.

51. In this example, charges are levied at 1/365% of the fund's daily value each day of the month. On the final day of each month, the member is also given a rebate

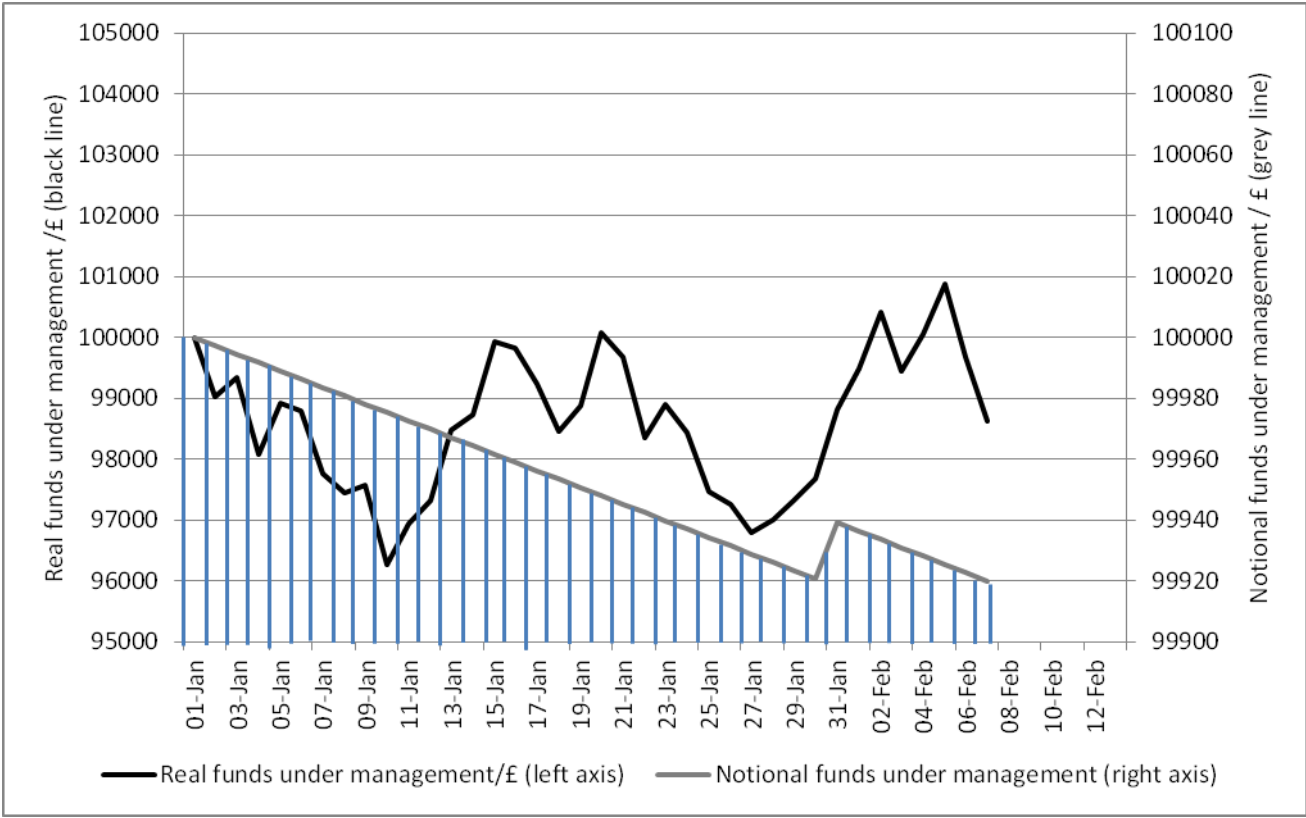
of the charges – this is why the grey line above shows a slight sawtooth pattern. The rebate is  $(m/365) \times 0.251\%$ , where m is the number of days in the month.

52. Because across the year a total of 1% is charged and a total of 0.251% is rebated, trustees may refer to this arrangement as having annual charges of 0.749%. Whether this is definitely compliant with the cap can be demonstrated by application of the prospective method of assessment.
53. The value of the member's funds (ignoring fluctuations, contributions and withdrawals) on each of the reference points is shown below.

<b>Date</b>	<b>Value</b>
1-Feb	£999.34
1-May	£997.51
1-Aug	£995.63
1-Nov	£993.75
<b>Average of reference point values</b>	<b>£996.56</b>
31-Dec (year end value)	£992.54

54. In this example, the member started the charges year with £1000. Under the charges regime set out above, this member's funds under management in the absence of fluctuations, contributions and withdrawals would at the end of the year be £992.54. The total level of charges that would be imposed on this member, in the absence of fluctuations, contributions and withdrawals, would therefore be  $£1000 - £992.54 = £7.46$ .
55. Expressed as a percentage of the average of the fund value at the 4 reference points, the charge for this member would be  $£7.46/£996.56$ , or 0.749%, which is indeed within the charge cap. The prospective method has therefore confirmed that the charge regime is compliant for a member who is invested at the start of the year, and remains invested for the rest of the year.
56. To be compliant with the cap overall, the regime needs to be compliant for all members, irrespective of when they first contribute or when they leave the scheme. The next chart gives an example of a case where a member leaves part way through the year, and charges levied in the final part-month are not rebated.

**Example 9: Daily reference points – member invested for part year – without final rebate**



57. As with example 8, the charges year again runs from 1 January to 31 December, and the scheme uses the same charges regime of a daily 1/365% charge with a monthly rebate on the final day of each month which attempts to bring the charges down to within the 0.75% cap.

58. However, in this example, daily reference points are used, which will generally be preferable for trustees and managers when charges are being deducted daily. The member is invested at the beginning of the year and has substantial funds under management, but 7 February is the last day they are invested in the fund.

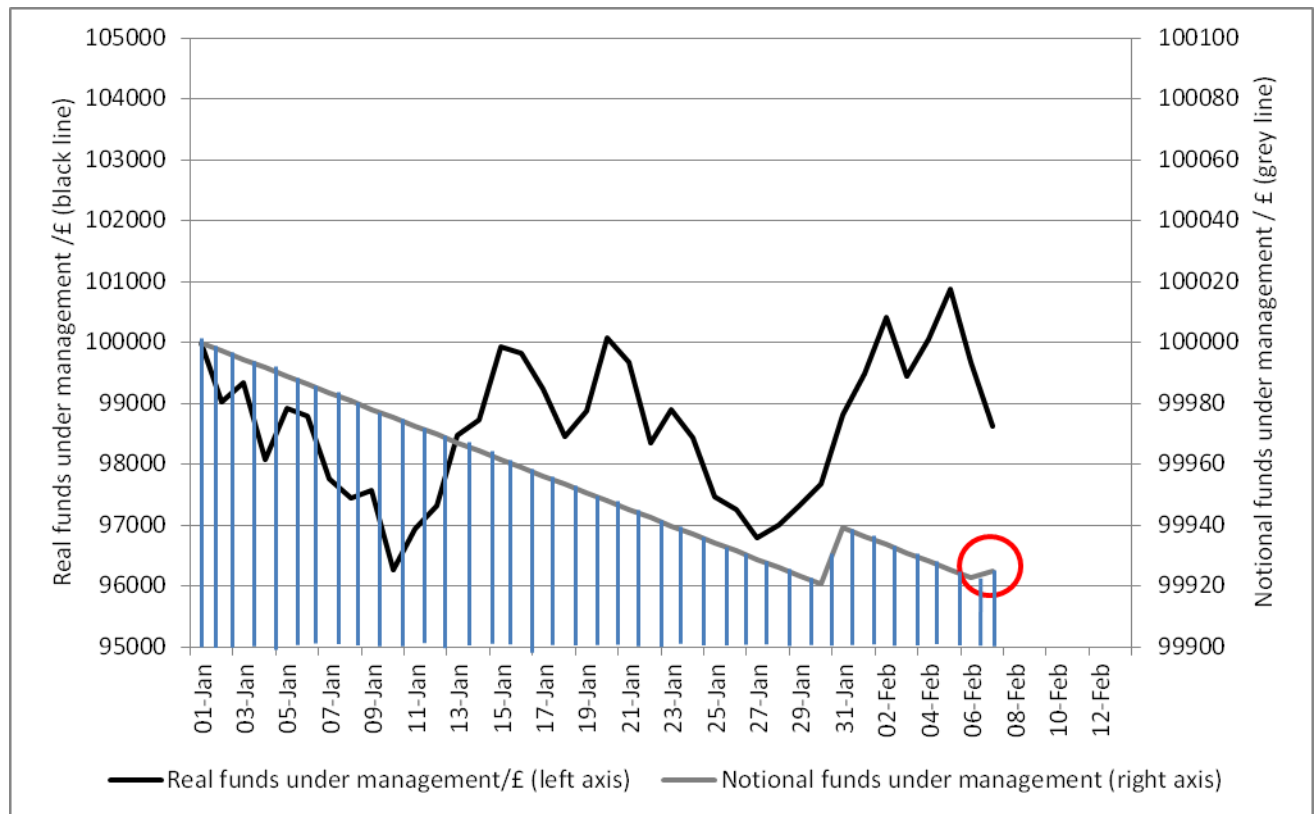
59. To confirm compliance for this member, trustees would again take the average of the fund values at all the reference points for which the member is invested in the charges year, taking no account of the fluctuations, member contributions or withdrawals, as before. These fund values are the intersections of the grey line and the blue lines in the chart above. The average value is £99,953.82. In this period £80.02 would be taken as charges. Thus the percentage of funds lost to charges is  $80.02 / 99953.82 = 0.08\%$ . As these are the charges paid over a period of 38 days, this is equivalent to an annual percentage charge of  $0.080 \times 365/38 = 0.77\%$ .

60. Therefore, whilst this charges regime complies with the cap for a member who remains invested over the whole charges year, it does not comply for a member who leaves mid-way through the year.



61. This is due to the details of the rebating system. The member has been charged at  $1/365\%$  from 1 January to 31 January, but has also received a rebate of  $31/365$  of  $0.25\%$  on 31 January to compensate. Then between 1 February and 7 February the member is again charged  $1/365\%$  each day, but on leaving the scheme they do not receive a rebate for the part of the month at which they were paying  $1\%$ . This systemic bias results in the overall charge breaching the cap.
62. In the example below, the charges regime is otherwise identical to that in example 9, except for a rebate which is payable when the member leaves mid-month.

**Example 10: Daily reference points – member invested for part year – with final rebate**



63. In this charges regime, the rebate of charges on the member's final day in the scheme is  $(n/365) \times 0.25\%$ , where  $n$  is the number of days which have elapsed since the last rebate. The result of the rebate is shown circled in red above – the value of the member's fund tilts upwards slightly just before exiting the scheme.

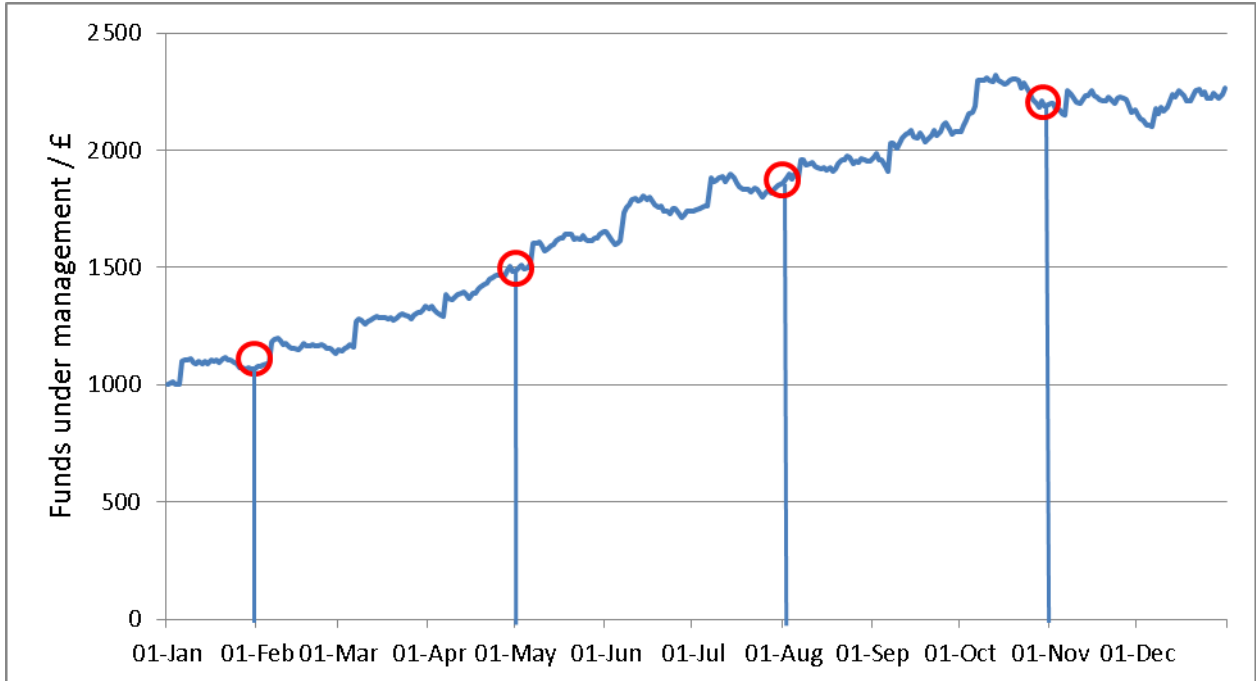
64. Here the average of fund values at the daily reference points is £99953.94. The total amount of charges levied is £75.21. This equates to charges of 0.075%. Grossed up to represent the charges across the whole year, this works out at 0.72%.

65. Although we have used just a single example to demonstrate this, the part-month final rebate means that the charges regime will ensure compliance with the cap, irrespective of when any member joins or leaves the scheme. Such an arrangement is therefore compliant with the cap, when assessed under regulation 8, and there is no requirement to prove compliance for each actual member.

66. It is worth noting finally that we have used a rebate which is equivalent to an annual figure of 0.251% in the examples above. A rebate of exactly 0.25% on a 1/365% daily charge would tend not to ensure charge compliance. This is because under the prospective method of assessment only the impact of the charges, not investment growth or contributions, are considered, so the fund value gradually erodes over time. This means in turn that up-front charges calculated on the basis of a higher fund value are never quite offset by a rebate calculated on the basis of a slightly lower fund value. However, a reduction in charge of the order of 0.1bps is easily enough to counteract this effect.

## Retrospective method of assessment - examples

### Example 11: Quarterly reference points – member invested for the whole year



67. In this example, the charges year runs from 1 January to 31 December. The quarterly reference points are set an equal number of months apart at 1 February, 1 May, 1 August and 1 November (as mentioned in box 1, there is no requirement for the charges year to begin or end with a reference point). The member is invested in the default arrangement throughout the charges year.

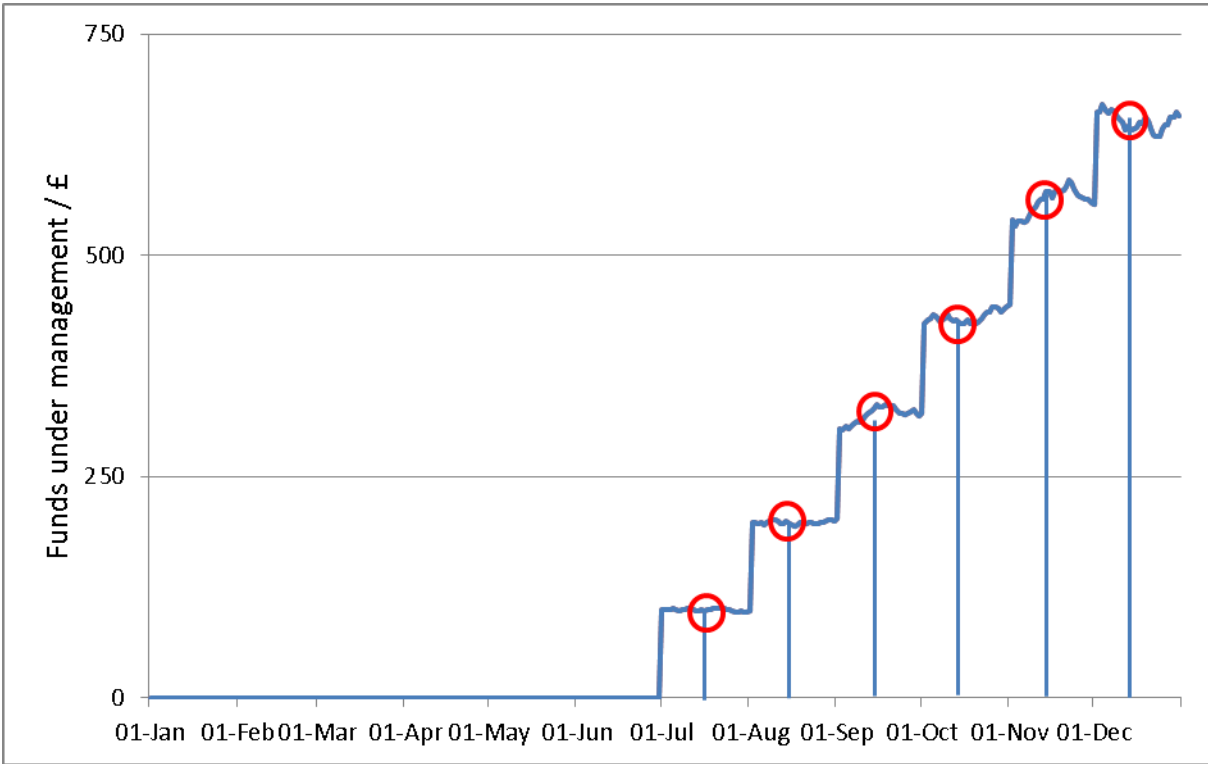
68. We are assuming that the member has £1000 invested at the start of the year and £100 per month contribution.

69. At the four reference points, the member's funds under management are as follows:

Date	Value
1-Feb	£1079.91
1-May	£1486.73
1-Aug	£1858.50
1-Nov	£2199.77
<b>Average</b>	<b>£1656.23</b>

70. The maximum charge which may be imposed on the member for the year is 0.75% of this figure, or **£12.42**.

**Example 12 –Monthly reference points - member invested for part of the year**



71. In this example the scheme year again runs 1 January to 31 December, with monthly reference points on the 15<sup>th</sup> of each month. The member’s first contribution to the default arrangement is allocated on 1 July. At the 6 reference points, the member’s funds under management are:

Date	Value
15-Jul	£98.91
15-Aug	£196.55
15-Sep	£330.96
15-Oct	£422.85
15-Nov	£571.47
15-Dec	£642.74
<b>Average</b>	<b>£377.25</b>

72. The member was only invested in the default arrangement from 1st July onward, which equates to 184 days of the charges year. Therefore in a scheme which only levies a funds under management charge (a single charge structure – regulation 5(2)), the maximum charge which could be imposed on the member is 0.75% x (184/365), or 0.378% of £377.25. This would mean a maximum charge of £1.43.

73. If this was instead a combination charge scheme consisting of a funds under management charge (the existing rights charge - regulation 5(3)(b)) with a contribution percentage charge (regulation 5(3)(a)) of, say, 1%:

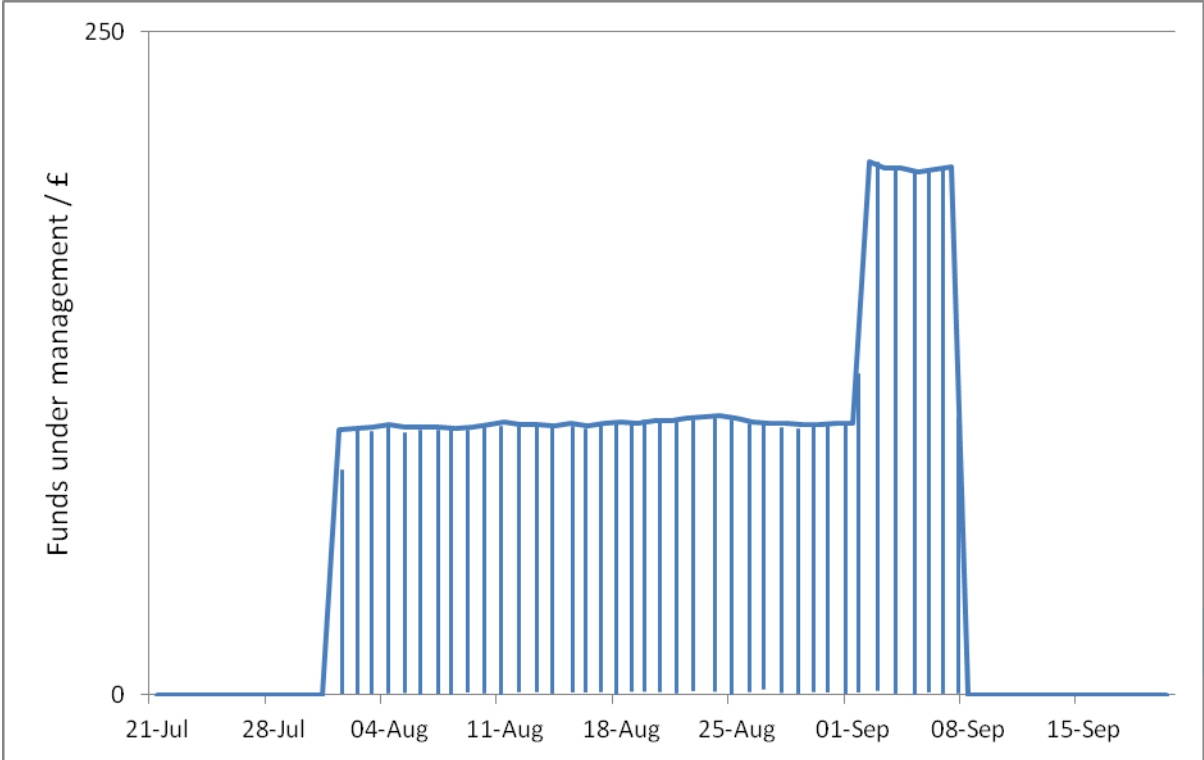
- the maximum funds under management charge would be 0.6% annually. Pro-rated, this would amount to  $0.60\% \times (184/365)$  or 0.302%.
- in contrast, the contribution charge is not pro-rated (regulation 6(3)(a)(ii)). This is because the charge is levied as a percentage on all contributions, regardless of whether those contributions are made for part of a year or a whole year. In the example above where the member contributes £100 per calendar month, or £600 over the year, the member can be charged 1% of £600 which works out at £6.

74.If this were the other kind of permitted combination charge structure, with an existing rights charge and a *flat fee charge* (regulation 5(3)(b)) of, say, £10:

- the maximum existing rights charge would again be 0.6%, pro-rated using the same method as above.
- the flat fee would also be pro-rated, at  $£10 \times (184/365)$  or £5.04.

75.If instead the member were invested for no reference points – so their funds were allocated to the default on 1 July and they transferred out on 14 July – then the value of their funds under management on 14 July would be used as the basis for confirming charge compliance. In a single charge scheme the maximum charge would be  $(14/365) \times 0.75\% \times$  the fund's value on 14 July.

**Example 13 – Daily reference points – member invested for part of the year**



76. In example 13 above, the scheme year again runs from 1 January to 31 December, with daily reference points. The member’s first contribution is allocated on 1 August, a second contribution on 1 September, and their last day of being invested in the default arrangement (for example, because they reach retirement and decumulate) is 7 September. The member was therefore invested for 38 days of the charges year.

77. The average value of the member’s funds over all 38 daily reference points is £117.33. Therefore the maximum charge which can be imposed on the member in a single charge structure for this period would be  $0.75\% \times £117.33 \times (38/365) = £0.09$ .

## Note on examples used in this section

78. The examples of charge assessment above and the underlying assumption are for illustration only. The information below is provided solely for information.

79. The assumptions are:

- the member contributes £100 per calendar month.
- underlying growth in the funds under management is 5% per year, but this is combined with daily random fluctuations of up to +/-1.4% of the funds under management.
- The real value of the member's funds each day is therefore the value of their funds on the previous day, plus the underlying growth plus or minus the fluctuations calculated as a percentage of the funds on the previous day, plus any contributions made by the member.

80. Some example-specific assumptions have also been made.

### Prospective method of assessment

- In example 8, the starting balance is £1000
- In examples 9 and 10, the starting balance is £100,000
- In examples 8 and 9, a charge of  $1/365\%$  of the funds under management is calculated and deducted each day. On the final day of each month a rebate of  $0.25\% \times (m/365)$  of the funds under management on that day is also paid to the member, where  $m$  is the number of days in the month.
- In example 10 a rebate for the final part-month of scheme membership is paid to the member, equal to  $0.25\% \times (n/365)$  of the funds under management, where  $n$  is the number of days in the part-month for which the member has been invested. In example 9, such a rebate is not paid.

### Retrospective method of assessment

- In examples 11, 12 and 13, no charges are assumed to be deducted during the charges year.