

<b>Title:</b> Introducing a cap on early exit charges in trust-based occupational pension schemes <b>IA No:</b> DWP09_2016 <b>RPC Reference No:</b> RPC-3341(1)-DWP <b>Lead department or agency:</b> Department for Work and Pensions <b>Other departments or agencies:</b> HM Treasury	<b>Impact Assessment (IA)</b>
	<b>Date:</b> May
	<b>Stage:</b> Consultation
	<b>Source of intervention:</b> Domestic
	<b>Type of measure:</b> Primary and Secondary legislation
<b>Contact for enquiries:</b> Jane Ball Jane.Ball3@dwp.gsi.gov.uk	
<b>Summary: Intervention and Options</b>	<b>RPC:</b> Green

Cost of Preferred (or more likely) Option				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2014 prices)	One-In, Three-Out	Business Impact Target Status
N/A at this stage	N/A at this stage	N/A at this stage	In scope	Qualifying provision

**What is the problem under consideration? Why is Government intervention necessary?**

In April 2015, the Government introduced pension freedoms enabling individuals aged 55 and over who are members of a defined contribution (DC) pension scheme to be able to access their pension pot as and when they want to (subject to their marginal rate of income tax, typically 20% or 40%). This is either via their current scheme or by transferring their savings to a scheme that offers flexible access options.

Scheme trustees and providers of services to those schemes have to cover their own costs and in some cases there will be business pressures to ensure this is profitable. The costs incurred will vary from scheme to scheme and will arise from setting up and maintaining services to the scheme on behalf of its members and the sponsoring employer. These costs and any profit will derive from the charges imposed on the scheme members and the charging structures will differ between schemes. The costs are spread over the member's accumulation period.

Many schemes may also impose additional charges on members when they make decisions about accessing their pension before the selected retirement date. These could include costs for transferring to another scheme that offers the pension freedoms. Joining fees, annual management charges and exit charges are all used as mechanisms to enable a provider to recover some or all of its set-up and on-going costs.

Between July and October 2015 HM Treasury ran a consultation to gather stakeholders and consumers views on whether early exit fees applied by schemes were preventing consumers from accessing their pension savings flexibly. The Financial Conduct Authority (FCA) and the Pensions Regulator (TPR) collected data on the prevalence of early exit charges. The data gathered proved that exit charges were currently imposed on members of contract-based and trust-based schemes aged 55 and over. The Government's consultation concluded that these charges were presenting significant barriers to those who incurred them and had the potential to prohibit individuals from accessing their pension benefits flexibly. Subsequently, the Government signalled its intention to cap early exit charges for members of contract-based schemes by legislating to give the FCA a duty to cap excessive early exit fees.

The Government wants to ensure that there is a level playing field where all scheme members who are eligible for the pension freedoms can access them easily, and at a reasonable cost regardless of whether they are in a trust or contract-based pension scheme.

**What are the policy objectives and the intended effects?**

The policy objective is to address concerns that members of trust-based occupational pension schemes are effectively being prohibited from accessing their pension before their selected retirement age or scheme maturity date because of early exit charges levied or imposed by the trustees or managers of the scheme. The Government wants to make it easier for individuals to access flexible benefits within the scheme or move between schemes to access their funds in the way they wish. The Government also wish to ensure that there is parity of treatment and protection for members of trust and contract-based pension schemes.

The Government has introduced legislation which will give the FCA a duty to make rules requiring relevant firms to limit the early exit charges imposed in relation to contract-based schemes, as set by the FCA. The FCA will set out its next steps in the process shortly with a view to implementing its duty to cap early exit fees in April 2017. To be effective, the cap on early exit fees needs to apply equally across the contract and trust-based market and be clearly enforceable by both regulators (FCA and TPR). To deliver this DWP and TPR will work in partnership with the FCA in the process of developing the design and level of the cap.

**What policy options have been considered, including any alternatives to regulation?**

This Impact Assessment considers the following options:

Option 0: Do nothing – so current exit charges will continue to apply in trust-based occupational pension schemes

Option 1: Introduce an exit charge cap at 2% of funds under management

Option 2: Introduce an exit charge cap at 3% of funds under management

Option 3: Introduce an exit charge cap at 5% of funds under management

Option 4: Introduce an exit charge cap at 7% of funds under management

Option 5: Introduce an exit charge cap at 10% of funds under management

A voluntary option has been ruled out as, in order to meet the policy objective, it would be necessary for all trust-based occupational pension schemes and third-party pension providers to support a voluntary approach; otherwise some customers may still be unable to access their pension at reasonable cost. It is likely that those firms that chose not to cap fees would have higher exit fees than the rest of the market and be the source of the highest levels of consumer detriment. A legislative approach is the only option that ensures all members are protected.

<b>Will the policy be reviewed?</b> No		<b>If applicable, set review date:</b> N/A			
Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope?	<b>Micro</b> YES	<b>&lt; 20</b> YES	<b>Small</b> YES	<b>Medium</b> YES	<b>Large</b> YES
What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent)			<b>Traded:</b> N/A		<b>Non-traded:</b> 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: 31/03/16

# Summary: Analysis & Evidence

# Policy Option 0

Description: Do nothing (baseline)

## FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	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	0	n/a	0	0
High	0		0	0
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'

If a cap is introduced for contract-based schemes but not trust-based schemes there could be a cost to providers who serve both sides of the market from having to maintain two different processes for implementing exit charges.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	n/a	0	0
High	0		0	0
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

Under the baseline scenario members will continue to face exit charges as now. An estimated 8,500 members aged 55 and above are expected to be accessing their pensions early and pay an exit charge in 2017 with an estimated £5.82m paid in total.

## BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target £m
Costs: 0	Benefits: 0	Net: 0	n/a

## Summary: Analysis & Evidence

## Policy Option 1

**Description:** Introduce an exit charge cap at 2% of funds under management

### FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	High: 0	Best Estimate: -0.89

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.3	0.9	8.6

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

- There would be costs to trust-based occupational pension schemes, providers and administrators from the charges foregone totalling around £3.88m in the first year and £0.51m in each subsequent year.
- There would be on-going administrative costs to schemes, providers or administrators from overriding existing charges each time a member exited the scheme early and the cap applied. In total these are estimated at £0.31m in the first year and £0.04m in each subsequent year.
- There would also be one-off familiarisation costs to schemes, providers or administrators to understand the scope of the cap, and where applicable, design a method for overriding the cap on a case by case basis. These are estimated at £0.28m in 2017. All figures are in 2015 constant price terms.

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

- There could be second order behavioural effects which have not been monetised. For example, from providers recouping costs elsewhere.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.0	0.8	7.7

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

- There would be benefits to members of trust-based occupational pension schemes where exit fees currently exceed the level of the cap. This is assumed to be equal to the costs to businesses from the charges foregone, at £3.88m in the first year and £0.51m in each subsequent year.

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

#### Key assumptions/sensitivities/risks

Discount rate (%) 3.5

There are uncertainties over future volumes of members that will leave their schemes early and face an exit charge. A cap on exit charges may lead to a second order effect where more people wish to exit and this would generate more charges to schemes. However, this effect has not been considered in the Impact Assessment.

### BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:	Score for Business Impact Target £m
Costs: 0.9      Benefits: 0.0      Net: 0.9	4.5

## Summary: Analysis & Evidence

## Policy Option 2

**Description:** Introduce an exit charge cap at 3% of funds under management

### FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	High: 0	Best Estimate: -0.75

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.3	0.8	7.3

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

- There would be costs to trust-based occupational pension schemes, providers and administrators from the charges foregone totalling around £3.30m in the first year and £0.43m in each subsequent year.
- There would be on-going administrative costs to schemes, providers or administrators from overriding existing charges each time a member exited the scheme early and the cap applied. In total these are estimated at £0.24m in the first year and £0.03m in each subsequent year.
- There would also be one-off familiarisation costs to schemes, providers or administrators to understand the scope of the cap, and where applicable, design a method for overriding the cap on a case by case basis. These are estimated at £0.28m in 2017. All figures are in 2015 constant price terms.

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

- There could be second order behavioural effects which have not been monetised. For example, from providers recouping costs elsewhere.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.0	0.7	6.6

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

- There would be benefits to members of trust-based occupational pension schemes where exit fees currently exceed the level of the cap. This is assumed to be equal to the costs to businesses from the charges foregone, at £3.30m in the first year and £0.43m in each subsequent year.

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

#### Key assumptions/sensitivities/risks

Discount rate (%) 3.5

There are uncertainties over future volumes of members that will leave their schemes early and face an exit charge. A cap on exit charges may lead to a second order effect where more people wish to exit and this would generate more charges to schemes. However, this effect has not been considered in the Impact Assessment.

### BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:	Score for Business Impact Target £m
Costs: 0.8      Benefits: 0.0      Net: 0.8	4.0

## Summary: Analysis & Evidence

## Policy Option 3

**Description:** Introduce an exit charge cap at 5% of funds under management

### FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)			
			Low: 0	High: 0	Best Estimate: -0.57	
<b>COSTS (£m)</b>	<b>Total Transition (Constant Price) Years</b>		<b>Average Annual (excl. Transition) (Constant Price)</b>		<b>Total Cost (Present Value)</b>	
Low	0.0		0.0		<b>0.0</b>	
High	0.0		0.0		<b>0.0</b>	
Best Estimate	0.3		0.6		<b>5.5</b>	
<b>Description and scale of key monetised costs by 'main affected groups'</b>						
<ul style="list-style-type: none"> <li>There would be costs to trust-based occupational pension schemes, providers and administrators from the charges foregone totalling around £2.50m in the first year and £0.33m in each subsequent year.</li> <li>There would be on-going admin costs to schemes, providers or administrators from overriding existing charges each time a member exited the scheme early and the cap applied. In total these are estimated at £0.14m in the first year and £0.02m in each subsequent year.</li> <li>There would also be familiarisation costs to schemes, providers or administrators to understand the scope of the cap, and where applicable, design a method for overriding the cap on a case by case basis. These are estimated at £0.28m in 2017. All figures are in 2015 constant price terms.</li> </ul>						
<b>Other key non-monetised costs by 'main affected groups'</b>						
<ul style="list-style-type: none"> <li>There could be second order behavioural effects which have not been monetised. For example, from providers recouping costs elsewhere.</li> </ul>						
<b>BENEFITS (£m)</b>	<b>Total Transition (Constant Price) Years</b>		<b>Average Annual (excl. Transition) (Constant Price)</b>		<b>Total Benefit (Present Value)</b>	
Low	0.0		0.0		<b>0.0</b>	
High	0.0		0.0		<b>0.0</b>	
Best Estimate	0.0		0.5		<b>5.0</b>	
<b>Description and scale of key monetised benefits by 'main affected groups'</b>						
<ul style="list-style-type: none"> <li>There would be benefits to members of trust-based occupational pension schemes where exit fees currently exceed the level of the cap. This is assumed to be equal to the costs to businesses from the charges foregone, at £2.50m in the first year and £0.33m in each subsequent year.</li> </ul>						
<b>Other key non-monetised benefits by 'main affected groups'</b>						
<b>Key assumptions/sensitivities/risks</b>					<b>Discount rate (%)</b>	3.5
There are uncertainties over future volumes of members that will leave their schemes early and face an exit charge. A cap on exit charges may lead to a second order effect where more people wish to exit and this would generate more charges to schemes. However, this effect has not been considered in the Impact Assessment.						

### BUSINESS ASSESSMENT (Option 3)

<b>Direct impact on business (Equivalent Annual) £m:</b>			<b>Score for Business Impact Target £m</b>
Costs: 0.6	Benefits: 0.0	Net: 0.6	3.0

## Summary: Analysis & Evidence

## Policy Option 4

**Description:** Introduce an exit charge cap at 7% of funds under management

### FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	High: 0	Best Estimate: -0.47

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.3	0.5	4.5

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

- There would be costs to trust-based occupational pension schemes, providers and administrators from the charges foregone totalling around £2.01m in the first year and £0.26m in each subsequent year.
- There would be on-going admin costs to schemes, providers or administrators from overriding existing charges each time a member exited the scheme early and the cap applied. In total these are estimated at £0.10m in the first year and £0.01m in each subsequent year.
- There would also be familiarisation costs to schemes, providers or administrators to understand the scope of the cap, and where applicable, design a method for overriding the cap on a case by case basis. These are estimated at £0.28m in 2017. All figures are in 2015 constant price terms.

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

- There could be second order behavioural effects which have not been monetised. For example, from providers recouping costs elsewhere.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.0	0.4	4.0

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

- There would be benefits to members of trust-based occupational pension schemes where exit fees currently exceed the level of the cap. This is assumed to be equal to the costs to businesses from the charges foregone, at £2.01m in the first year and £0.26m in each subsequent year.

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

#### Key assumptions/sensitivities/risks

Discount rate (%) 3.5

There are uncertainties over future volumes of members that will leave their schemes early and face an exit charge. A cap on exit charges may lead to a second order effect where more people wish to exit and this would generate more charges to schemes. However, this effect has not been considered in the Impact Assessment.

### BUSINESS ASSESSMENT (Option 4)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target £m
Costs: 0.5	Benefits: 0.0	Net: 0.5	2.5

## Summary: Analysis & Evidence

## Policy Option 5

**Description:** Introduce an exit charge cap at 10% of funds under management

### FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	High: 0	Best Estimate: -0.41

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.3	0.3	3.4

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

- There would be costs to trust-based occupational pension schemes, providers and administrators from the charges foregone totalling around £1.50m in the first year and £0.19m in each subsequent year.
- There would be on-going admin costs to schemes, providers or administrators from overriding existing charges each time a member exited the scheme early and the cap applied. In total these are estimated at £0.07m in the first year and £0.01m in each subsequent year.
- There would also be familiarisation costs to schemes, providers or administrators to understand the scope of the cap, and where applicable, design a method for overriding the cap on a case by case basis. These are estimated at £0.28m in 2017. All figures are in 2015 constant price terms.

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

- There could be second order behavioural effects which have not been monetised. For example, from providers recouping costs elsewhere.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low	0.0	0.0	0.0
High	0.0	0.0	0.0
Best Estimate	0.0	0.3	3.0

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

- There would be benefits to members of trust-based occupational pension schemes where exit fees currently exceed the level of the cap. This is assumed to be equal to the costs to businesses from the charges foregone, at £1.50m in the first year and £0.19m in each subsequent year.

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

<b>Key assumptions/sensitivities/risks</b>	<b>Discount rate (%)</b>	3.5
There are uncertainties over future volumes of members that will leave their schemes early and face an exit charge. A cap on exit charges may lead to a second order effect where more people wish to exit and this would generate more charges to schemes. However, this effect has not been considered in the Impact Assessment.		

### BUSINESS ASSESSMENT (Option 5)

<b>Direct impact on business (Equivalent Annual) £m:</b>	<b>Score for Business Impact Target £m</b>	
Costs: 0.4	Benefits: 0.0	Net: 0.4
		2.0



## Evidence Base (for summary sheets)

### Problem under consideration

1. As of 6 April 2015, individuals aged 55 and over who have flexible benefits (DC and cash balance benefits) are entitled to access their pension pot flexibly, regardless of their total pension savings. Before the introduction of these historic reforms, the vast majority of individuals would have been subject to a 55% tax penalty for withdrawing their pension benefits fully. Individuals are now able to access their flexible benefits as they wish, subject to their marginal rate of income tax (typically 20% or 40%). Individuals with defined benefit (DB) pension savings that are not already in payment can transfer their DB savings to a defined contribution (DC) scheme if they want to access their pension savings flexibly, provided that they are more than one year away from their scheme retirement date.
2. The Government aims to ensure that everyone in a DC scheme can access their pension savings flexibly even if their scheme does not offer flexible access. To enable this it strengthened members' statutory right to transfer pension savings between DC schemes, and empowered trustees and managers of pension schemes to override their own scheme rules in relation to transfers.
3. Whilst there is no requirement for pension providers to offer flexible access products to their scheme members, the pension freedoms are expected to encourage pension schemes and providers to innovate and develop products according to the needs of their scheme members in an evolving pensions landscape. The extended transfer rights ensure that people are not prevented from accessing their pension savings in the way that they want.
4. As individuals have sought to engage with the new pension freedoms the Government has become increasingly aware that early exit charges are acting as a financial barrier to some members who decided to exit their scheme selected retirement date in order to access their pension savings flexibly. The level of the exit charge (either in absolute terms or relative to the size of their pension pot) could, in some instances, be high enough that it is no longer economic for an individual to access their pension flexibly; whilst in others, the presence of an early exit charge could act to discourage individuals from accessing their pension when it might be beneficial in their circumstances.
5. Between July to October 2015, HM Treasury ran a consultation "Pensions Transfers and Early Exit Charges"<sup>1</sup> It considered the issues around early exit charges to ensure that people are not facing unjustifiable charges when moving scheme or accessing their pension savings flexibly within their scheme as part of the new freedoms. The consultation also sought views on how the process for transferring pensions from one scheme to another could be made quicker and smoother. The Government provided a formal response to the consultation in February 2016<sup>2</sup>. This confirmed that a cap on early exit fees would be introduced to ensure that these charges do not create a barrier to

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<sup>1</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/449861/PU1847\\_Pensions\\_transfers\\_v4.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/449861/PU1847_Pensions_transfers_v4.pdf)

<sup>2</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/498871/pension\\_transfers\\_and\\_early\\_exit\\_charges\\_response.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/498871/pension_transfers_and_early_exit_charges_response.pdf)

consumers who want to access their pension savings flexibly. For contract-based schemes the intention is that a cap will come into force by Spring/Summer 2017 but the level is still to be determined. Whatever the precise level of the cap it will have the effect of reducing the amount paid by some individuals.

## Rationale for intervention

6. There is a risk that prioritising protection of those in contract-based schemes over those in trust-based occupational pension schemes could damage the positive impact these measures would otherwise have.
7. Scheme trustees and providers of services of those schemes have to cover their own costs and in some cases there will be business pressures to ensure this is profitable. The costs incurred will vary from scheme to scheme and will arise from setting up and maintaining services to the scheme on behalf of its members and the sponsoring employer. These costs and any profit will derive from the charges imposed on the scheme members and the charging structures will differ between schemes. The costs are spread over the member's accumulation period.
8. Many schemes may also impose additional charges on members when they make decisions about accessing their pension before the selected retirement date. These could include costs for transferring to another scheme that offers the pension freedoms. Joining fees, annual management charges and exit charges are all used as mechanisms to enable a provider to recover some or all of its set-up and on-going costs. There are three main ways that set-up costs can be recovered:
  - Set up costs paid up front by each saver. This means that the impact of charges is high at the start, but is lower going forward. Under this charging structure, there are no exit charges. Each saver pays their own set up costs but a saver who leaves the scheme before the selected retirement date will have lost a high proportion of their contributions and fund value to charges arising from these initial charges.
  - Set up costs paid by everyone who remains in a scheme. All savers pay the same ongoing charge as a proportion of their funds, (for example though an annual management charge (AMC)) but no joining or exit charge. Because there is no joining or exit charge, the provider is likely to recover the set up costs of those savers that leave early by charging a higher ongoing rate, which will ultimately be paid by those savers that remain in the scheme. This means long term savers bear a share of the set up costs of savers who exit the scheme before the selected retirement age.
  - Set up costs paid over the lifetime or at exit. Savers do not pay an initial charge. However, should a saver leave the scheme before the selected retirement age they will pay an exit charge to cover the proportion of set-up costs that have not been recovered through regular charges (e.g. an AMC). This charge will diminish the longer the saver remains in the scheme. As all savers that exit pay their own set-up costs, these costs do not need to be recovered from savers that remain in the scheme for longer.
9. To inform the Government consultation, the Financial Conduct Authority (FCA) and the Pensions Regulator (TPR) collected data that indicated that early exit charges pose a

potentially significant barrier for a minority of individuals in contract-based pension arrangements (regulated by the FCA) and trust-based pension arrangements (regulated by TPR) who wish to access their pension benefits flexibly.

10. FCA data from September 2015 showed that around 16% of consumers eligible to access their pension savings would be charged a penalty if they opted to leave the scheme before the selected retirement age in contract-based pension schemes. The majority (nearly 80%) of those where a percentage charge would apply, face a charge of up to 5% of the fund value<sup>3</sup>.
11. The TPR survey of flexible pension access<sup>4</sup>, covering the same period, showed that 11% of trust-based schemes charged at least one exit fee, reducing to around 7% if just considering the types of exit fee that would most likely be included in a cap<sup>5</sup>. Exit fees were more likely to be present in smaller, rather than larger schemes or Master Trusts. As the vast majority of trust-based pension scheme members are in Master Trusts or medium and large schemes this means up to 6% of members faced exit charges, reducing to around 3% for charges relevant to a potential cap. The average flat fee charged was £195 and the average percentage fee was 10% although the majority had fees ranging from 1% to 5%<sup>6</sup>. The TPR survey<sup>7</sup> (May 2016) broadly confirms these findings with 3% of members facing exit charges and 4% of trust-based schemes charging an early exit fee which would be in scope of the cap.
12. To address this, the Government has signalled its intention to cap early exit charges for members of contract-based schemes by legislating to give the FCA a duty to cap excessive early exit fees. It wants to ensure that there is a level playing field where all customers who are eligible can access the pension freedoms easily, and at a reasonable cost regardless of whether they are in a trust or contract-based pension scheme.
13. When employers select a pension scheme for their employees they can select either an arrangement that is a bundle of individual contracts (termed a contract-based scheme) or a scheme operated under trust (termed a trust-based scheme). Trust-based schemes can be pre-designed by a pension provider and be linked to contractual arrangements between the trustees and the provider. Consequently, in effect, the pension scheme provider imposes the terms and conditions on the member of these trust-based schemes.
14. The Government needs to strike the right balance between effective competition and appropriate consumer protection. The intention, therefore, is not to prevent pension scheme providers from applying an early exit charge but to ensure the appropriate level is set to reflect the costs of running the scheme without placing excessive penalties on the consumer.

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<sup>3</sup> FCA Pension freedoms data collection exercise: analysis and findings, September 2015

<sup>4</sup> TPR: Survey of flexible pension access, September 2015

<sup>5</sup> For example, fees associated with setting up an Uncrystallised Fund Pensions Lump Sum (UFPLS) and Market Value Adjustments are not expected to be included in an exit charge cap.

<sup>6</sup> These figures include two or three outliers which skew the average.

<sup>7</sup> [www.tpr.gov.uk/exit](http://www.tpr.gov.uk/exit)

15. For trust-based schemes, discussions with the industry have revealed that early exit fees are mainly present in schemes set up in the 1980s and 1990s before the introduction of stakeholder pensions in 2000. At this time there were often significant costs incurred by the provider in setting up the trust-based scheme, including the costs of 'selling' the policy to the employer. A common practice to recoup these costs was for the provider to use a structure which levied higher charges in the first few years of membership with the amount charged declining as the member converged on their normal pension age. Where the member left the scheme before the selected retirement age a fee was charged to recoup the charges that would have otherwise been paid until the normal pension age.
16. Consequently, this type of charging structure will have been imposed by the underlying insurance provider rather than the trustees themselves. These charging structures had the benefit of having fewer upfront costs for the employer as the set up costs are recouped from the members themselves over time, and often there may have been loyalty bonuses for members that continue to contribute until their normal pension age. This would make the scheme attractive to the employer on the face of it, but would not necessarily be the best choice for the member, particularly where the member wishes to leave the scheme before the selected retirement age. This is an example of **information asymmetry** where the complexity of the product creates difficulties for employers in making comparisons about costs and quality, and outcomes may not be judged for a number of years and depend upon certain factors.
17. The result is that there are members of older trust-based schemes who had no choice about the charging structure of the scheme they entered who may wish to leave the scheme early but face substantial charges. This is an example of the **principle-agent problem** where scheme members rely on employers to select a workplace scheme into which they are enrolled and their respective interests and incentives are often different.
18. Government intervention is required to address the information asymmetry and principle-agent problem so that members' interests are protected. There is clear economic rationale for this change. The fees act as a barrier to free choice of pension funds, locking in initial decisions that may now be sub-optimal, by increased costs of changing provider. Where it may be optimal for individuals to change supplier as their preference is for early access to funds high exit charges act as a penalty for doing so.
19. The Government recognises that there are some costs involved in this process, therefore, charges would be capped to a level it believes is reasonable to cover those.
20. Increased mobility of funds in the market is expected to increase competitiveness and innovation in products over the longer term. People will no longer be tied to incumbent firms with products that no longer suit their needs.
21. The Government understands that providers tend to impose charges across their entire book irrespective of whether the member is in a contract or trust-based scheme. Limiting a cap to contract-based schemes would lead to inconsistencies of approach and could place additional burdens on those providers who would have to differentiate between those contracts supporting contract-based schemes and those supporting trust-based schemes.
22. Market value adjustments (MVAs) will not be included in the definition of an early exit fee. These take the form of an adjustment to the underlying value of a person's rights in a with-

profit fund contract when that individual leaves the scheme before their selected retirement date. The rationale behind this decision is that since customers are signing up to a long-term contract, early exits can disrupt insurers long-term pricing models built to incorporate long-term factors such as changes in interest rates.

### **Policy objectives**

23. The policy objective is to address concerns that members of trust-based pension schemes are effectively being prohibited from accessing their pension before their selected retirement age, because of early exit charges levied or imposed by the pension scheme provider. The Government wants to make it easier for individuals to move between schemes to access their funds in the way they wish. The Government also wish to ensure that there is parity of treatment and protection for members of trust and contract-based pension schemes.
24. The Government's consultation "Pensions Transfers and Early Exit Charges", covered earlier in this Impact Assessment considered options to limit early exit charges and to create a level playing field where all consumers can access the new pension freedoms easily and at reasonable cost.
25. To address this, DWP intend to bring forward legislation at the earliest opportunity to cap excessive early exit fees to ensure that members of trust-based schemes have the same protection as those in contract-based schemes.

### **Description of options considered**

26. To deliver a cap on exit fees, DWP and TPR will work in partnership with the FCA to develop the design and level of the cap and align this between both contract and trust-based schemes. Part of the process will involve looking at specific cost-benefit analysis and building on the data gathering exercises which have been undertaken by the FCA and TPR. The following options have or are being considered.

#### Do nothing

27. This option represents the baseline where exit fees can continue to be charged at any level. This will mean members who are in schemes with exit charges will continue to face costs that potentially deter them from accessing their pension savings. This would not meet the policy objective and has been ruled out.

#### Voluntary Approach

28. A possible voluntary cap on early exit charges was ruled out during the "Pensions Transfers and Early Exit Charges" initial stage consultation. The primary benefit of a voluntary approach is that it could be implemented very quickly without the need for legislative intervention. Some providers and schemes have already announced they are considering how they can eliminate or reduce exit charges levied and some have

committed to capping them<sup>8</sup>. However, in order to be effective, it would be necessary for *all* pension providers and trust-based schemes to support a voluntary approach; otherwise some customers may still be unable to access their pension at reasonable cost.

29. It is likely that those firms that chose not to cap fees (and instead face potential reputational damage) would have higher exit fees than the rest of the market and be the source of the highest levels of consumer detriment. There is concern that industry will pick the level of the cap based on their requirements rather than individual needs. A purely voluntary solution is unlikely to achieve the objective of removing the financial barrier that early exit charges pose to all consumers wishing to access their pension flexibly. The risk of non-compliance resulting in incomplete coverage means this option was also ruled out. Furthermore, there would be resulting challenges and costs in monitoring such a policy.
30. Therefore, the introduction of a legislative cap on early exit charges is the Government's preferred approach. The options considered below have been designed to give an indication of the impacts from different levels of a cap, expressed as a percentage of funds under management. The exact level of the cap will be determined following the consultation.
  - Option 1: Exit charge cap at 2% of funds under management;
  - Option 2: Exit charge cap at 3% of funds under management;
  - Option 3: Exit charge cap at 5% of funds under management;
  - Option 4: Exit charge cap at 7% of funds under management;
  - Option 5: Exit charge cap at 10% of funds under management.

### **Monetised and non-monetised costs and benefits**

31. A cap on exit fees, whether as a percentage or cash amount paid, would benefit affected members who wish to withdraw their pension funds or seek to move them between pension funds by reducing the charges paid and removing a potential actual, or perceived, barrier from being able to access the freedoms.
32. Pension schemes (or their third-party providers) that currently charge an exit fee above the level of the cap will face a loss of revenue. The costs to business from charges foregone are calculated as the difference between the total amount of exit charges currently paid with and without a cap. Assuming schemes do not attempt to recoup this revenue by other means, there would be an equal and opposite benefit to members.
33. There would also be some administrative costs to pension schemes and administrators from familiarisation with the new rules and implementation of the cap. The costs would depend on how the cap is implemented.

### **Baseline – do nothing**

34. In the baseline scenario, early exit charges will continue to exist as they are now. The total amount of exit charges paid in the future will be a function of:

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<sup>8</sup> For example, one provider has committed to capping exit charges at less than 5%. <http://www.ftadviser.com/2016/03/14/pensions/personal-pensions/prudential-cuts-charges-by-and-scraps-exit-fee-AFUG5Yo4XLk34eXA4hbvnK/article.html>

- the number of trust-based members in a DC scheme where exit fees apply;
- the proportion of these members who are eligible to access their pot flexibly (i.e. aged 55+) and wishing to exit their current scheme with existing exit charges to do so; and
- the levels of exit fees charged.

### *Number of members facing exit charges*

35. TPR data shows there are just over 7 million members of trust-based DC schemes or DC sections of hybrid schemes<sup>9</sup>. A recent TPR survey on exit fees<sup>10</sup> shows that around 3% of trust-based DC members (in schemes with 12 or more members) face an early exit charge of the type that would be in scope of a cap. For Small Relevant Schemes (SRS) with between 2 and 12 members, intelligence from FCA suggests exit charges tend to be more prevalent, particularly for the subset that are Executive Pension Plans<sup>11</sup> (EPPs) where up to 70% may incur exit charges. Applying the 3% to the total number of members in schemes with 12 or more members and 70% to members in SRSs gives an estimated 260,000 members of any age potentially facing exit charges.

### *Proportion of members who are eligible and wishing to exit their current scheme*

36. Of all trust-based DC members facing exit charges, only those aged 55 or above will be eligible to access the freedoms immediately and therefore be affected by any cap in the first year. An estimated 12% of trust-based DC members with 12 or more members are aged 55 or above.<sup>12</sup> For members of EPPs we assume 34% are aged 55+ based on the age profile of directors and senior managers<sup>13</sup>. Applying these percentages to the 260,000 members of any age gives approximately 42,300 members eligible for the freedoms and facing an exit charge in the first year.

37. Not all of these members would necessarily want, or need, to exit their scheme. An estimate can be derived by considering the take-up of the flexibilities to date. FCA report that in the first quarter since April 2015 a total of 204,581 pension policies were accessed, and in the next quarter 178,990 were accessed<sup>14</sup>. If we assume that latest quarter is more representative of volumes for the rest of the year (as the first quarter will include an element of 'pent-up' demand) this would give a total of 740,000 pension policies accessed in 2015/16. This compares to a total of 4.38 million pension policies held by members

<sup>9</sup> TPR - DC trust: a presentation of DC scheme return data 2015-16. The figure includes members of DC only schemes, dual-section hybrids schemes and micro schemes

<sup>10</sup> Findings to be published in due course. TPR excluded micro-schemes (with between 2 and 11 members) from the survey to maintain consistency with other data collection and research.

<sup>11</sup> An Executive Pension Plan (EPP) is an occupational money purchase arrangement normally used for a small number of directors and senior employees.

<sup>12</sup> DWP calculation from TPR scheme return data 2015/16 on the number of trust-based members aged 50+ and the proportion of active DC members aged 55-59 from Annual Survey of Hours and Earnings (ASHE) 2015.

<sup>13</sup> Age profiles by occupation type come from the Annual Survey of Hours and Earnings (ASHE) 2015. Occupations considered were "Managers, directors and senior officials", "Corporate managers and directors" and "Other managers and proprietors".

<sup>14</sup> FCA – Retirement Income Market Data, July to September 2015, published January 2016.

aged 55 and above in schemes regulated by the FCA<sup>15</sup>. Comparing these figures gives an indicative take-up rate of 17%<sup>16</sup>.

- 38. However, as the total number of eligible pension policies stated above may include some individuals who are over their selected retirement age and therefore would not benefit from any cap on early exit fees, we have instead used 20% as the estimated “take-up rate” to account for this factor.<sup>17</sup>. Applying this to the 42,300 members facing an exit fee, gives an estimated 8,500 as the total number of members in scope in the first year if a cap were applied (depending on the level of the cap).
- 39. For the purposes of this assessment we assume that every person would make a decision on whether to access their pensions before the selected retirement age early at the earliest opportunity. Therefore, in the first year of the policy we assume all 8,500 would potentially be affected.
- 40. In each year after the first year of the policy’s implementation, we assume the only people who would access their pensions early would be those reaching age 55 in that year<sup>18</sup>. ONS population projections<sup>19</sup> show that there are 894,000 people in the UK aged 54 in 2016 (so will turn 55 in 2017 when the policy is introduced). This represents 13% of all UK adults aged 55 to State Pension age in 2016, which we use as a proxy for the age of those eligible for the cap in the first year. Therefore, we assume that the number of people affected each year from 2018 onwards will be around 1,100, 13% of the 8,500 members in scope in 2017<sup>20</sup>.

Table 1: Estimated number of pensions accessed each year where an exit fee applies

2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
8,500	1,100	1,100	1,100	1,100	1,100	1,100	1,100	1,100	1,100

*The level of exit fees charged*

- 41. The TPR survey of flexible pension access shows the average flat exit fee charged was £195 and the average percentage fee was 10%<sup>21</sup> although the majority had fees ranging from 1% to 5%. However, given the small sample sizes, it is difficult to know more precisely how the levels of fees are distributed.

<sup>15</sup> FCA reported that there were 4,086,000 pension pots relating to people aged 55+ in their data collection exercise published in September 2015. As their survey represented approximately 94% of the total market, the total amount of pension pots in the market would be approximately 4,348,800.

<sup>16</sup> Note that this proportion is based on members of contract-based pension schemes rather than trust-based which is of interest here. However, there is no evidence to suggest that the take up of the freedoms should be fundamentally different in trust-based, rather than contract-based, DC schemes.

<sup>17</sup> This assumption is consistent with that used by HMT in their initial impact assessment

<sup>18</sup> This is a simplifying assumption to be able to calculate costs in subsequent years. In reality not everyone affected will want to access their pots immediately when they reach age 55 but it should provide a reasonable guide to the likely future volumes.

<sup>19</sup> ONS: 2014-based principle UK population projections

<sup>20</sup> This calculation provides illustrative future volumes based on an assumption that the population is static over time.

<sup>21</sup> TPR: Survey of flexible pension access, September 2015



42. As an alternative, more accurate way to estimate, we can use the range of charge levels applied in contract-based schemes instead, derived from FCA's data collection from September 2015. Several large pension providers have reported to the FCA, that where they operate in both the contract and trust side of the market, their charging structures for the two markets are aligned or very similar, so it is reasonable to apply the range of charge levels in contract-based schemes to trust-based schemes.
43. The FCA data provides the proportion of pots relating to members aged 55 that fall into different bands of exit charges, and allows us to calculate the average exit charge in each of the bands for contract-based schemes. This calculation is consistent with HMT analysis on the impacts of an exit charge cap for contract-based schemes. More details on the calculation are provided in the Annex.
44. Table 2 below then applies the distribution and mean exit charges in each band for contract-based pensions to the estimated number of trust-based members directly affected by the cap in the first year (8,500) to estimate a total amount of charge paid without a cap of £5.82m.

Table 2: Distribution of exit charges faced by trust-based members for those potentially affected by the cap

Charge %	Mean exit charge in this band (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
0-1	£83.80	3,067	£257,013
1-2	£251.41	1,464	£368,069
2-3	£419.01	896	£375,472
3-4	£586.62	682	£399,799
4-5	£754.22	505	£380,761
5-6	£921.83	442	£407,202
6-7	£1,089.43	177	£192,496
7-8	£1,257.04	151	£190,380
8-9	£1,424.64	126	£179,804
9-10	£1,592.25	114	£180,861
10-15	£2,095.06	328	£687,484
15-20	£2,933.09	240	£703,349
20-40	£5,028.15	215	£1,078,822
40+	£8,380.24	50	£423,067
Total		8,456	£5,824,580

#### Exit charges foregone with a cap

45. For the purposes of this assessment, we have assumed that a percentage cap rather than a flat monetary cap would be imposed (although the exact details of the cap will be determined following DWP and FCA consultations). Exit charges are often expressed in percentage terms as many of the costs incurred by exiting a pension scheme are proportionate to the size of the pension pot.

46. The analysis below considers the charges foregone under five scenarios - where there is a percentage cap imposed at 2%, 3%, 5%, 7% and 10% of the pot. The actual level of the cap will be determined following the consultation and may be different to the scenarios considered here.
47. With an exit charge cap, the amount of charge paid by each individual would either be:
- the same as currently if the current charge level is below the cap; or
  - the maximum charge if the current charge level is above the cap (i.e. pot size \* charge cap rate).
48. For example, if the cap were set at 2%, then the charges on the 4,531 pension pots with a charge of between 0 to 1% and 1 to 2% (from Table 2) would remain the same as before in the first year of the policy, with total charges paid at £625,082. However, the 896 pots where the charge is between 2 and 3% would only pay the capped 2% rate, averaging £335<sup>22</sup>, so the total charge for this group would fall from £375,472 to £300,378 and similarly for other individuals facing charges above 3%.

### **2% exit charge cap**

49. Table 3 below shows that under a 2% cap the estimated total charges received would be £1.94 million. This means the total estimated charges foregone under a 2% cap are £3.88 million (£5.82m minus £1.94m) with 3,925 members directly benefitting.

Table 3: Total charges faced by trust-based members exiting early under a 2% cap

Charge %	Mean exit charge in this band with a 2% cap (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
0-1	£83.80	3,067	£257,013
1-2	£251.41	1,464	£368,069
2-3	£335.21	896	£300,378
3-4	£335.21	682	£228,456
4-5	£335.21	505	£169,227
5-6	£335.21	442	£148,074
6-7	£335.21	177	£59,229
7-8	£335.21	151	£50,768
8-9	£335.21	126	£42,307
9-10	£335.21	114	£38,076
10-15	£335.21	328	£109,998
15-20	£335.21	240	£80,383
20-40	£335.21	215	£71,921
40+	£335.21	50	£16,923

<sup>22</sup> This is 2% of the illustrative average pot size of £16,760 which was assumed as part of the iterative process to calculate Table A2 in the Annex.

Total		8,456	£1,940,822
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### 3% exit charge cap

50. Table 4 shows the same analysis but with a 3% cap. Under this scenario the total estimated charges foregone are £3.30 million with 3,029 members directly benefitting.

Table 4: Total charges faced by trust-based members exiting early under a 3% cap

Charge %	Mean exit charge in this band with a 3% cap (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
0-1	£83.80	3,067	£257,013
1-2	£251.41	1,464	£368,069
2-3	£419.01	896	£375,472
3-4	£502.81	682	£342,685
4-5	£502.81	505	£253,840
5-6	£502.81	442	£222,110
6-7	£502.81	177	£88,844
7-8	£502.81	151	£76,152
8-9	£502.81	126	£63,460
9-10	£502.81	114	£57,114
10-15	£502.81	328	£164,996
15-20	£502.81	240	£120,574
20-40	£502.81	215	£107,882
40+	£502.81	50	£25,384
Total		8,456	£2,523,597

### 5% exit charge cap

51. Table 5 shows the same analysis but with a 5% cap. Under this scenario the total estimated charges foregone are £2.50 million with 1,843 members directly benefitting.

Table 5: Total charges faced by trust-based members exiting early under a 5% cap

Charge %	Mean exit charge in this band with a 5% cap (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
0-1	£83.80	3,067	£257,013
1-2	£251.41	1,464	£368,069
2-3	£419.01	896	£375,472
3-4	£586.62	682	£399,799
4-5	£754.22	505	£380,761
5-6	£838.02	442	£370,184
6-7	£838.02	177	£148,074

7-8	£838.02	151	£126,920
8-9	£838.02	126	£105,767
9-10	£838.02	114	£95,190
10-15	£838.02	328	£274,994
15-20	£838.02	240	£200,957
20-40	£838.02	215	£179,804
40+	£838.02	50	£42,307
Total		8,456	£3,325,309

### **7% exit charge cap**

52. Table 6 shows the same analysis but with a 7% cap. Under this scenario the total estimated charges foregone are £2.00 million with 1,224 members directly benefitting.

Table 6: Total charges faced by trust-based members exiting early under a 7% cap

Charge %	Mean exit charge in this band with a 7% cap (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
0-1	£83.80	3,067	£257,013
1-2	£251.41	1,464	£368,069
2-3	£419.01	896	£375,472
3-4	£586.62	682	£399,799
4-5	£754.22	505	£380,761
5-6	£921.83	442	£407,202
6-7	£1,089.43	177	£192,496
7-8	£1,173.23	151	£177,688
8-9	£1,173.23	126	£148,074
9-10	£1,173.23	114	£133,266
10-15	£1,173.23	328	£384,991
15-20	£1,173.23	240	£281,340
20-40	£1,173.23	215	£251,725
40+	£1,173.23	50	£59,229
Total		8,456	£3,817,125

### **10% exit charge cap**

53. Finally Table 7 shows the same analysis under a 10% cap. Under this scenario the total estimated charges foregone are £1.50 million with 833 members directly benefitting.

Table 7: Total charges faced by trust-based members exiting early under a 10% cap

Charge %	Mean exit charge in this band with a 10% cap (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
0-1	£83.80	3,067	£257,013

1-2	£251.41	1,464	£368,069
2-3	£419.01	896	£375,472
3-4	£586.62	682	£399,799
4-5	£754.22	505	£380,761
5-6	£921.83	442	£407,202
6-7	£1,089.43	177	£192,496
7-8	£1,257.04	151	£190,380
8-9	£1,424.64	126	£179,804
9-10	£1,592.25	114	£180,861
10-15	£1,676.05	328	£549,988
15-20	£1,676.05	240	£401,914
20-40	£1,676.05	215	£359,607
40+	£1,676.05	50	£84,613
Total		8,456	£4,327,979

54. Tables 3-7 examine the charges foregone in the first year of the policy. In subsequent years we assume the same distribution of charge levels apply and base the costs of the estimated 1,100 members affected in each subsequent year (which are assumed to be 13% of the year 1 volumes as shown in Table 1). This gives annual charges foregone as set out in Table 8.

Table 8: Estimated charges foregone in first year and each subsequent year

	Charges foregone in first year	Charges foregone in each subsequent year
2% cap	£3.88m	£0.51m
3% cap	£3.30m	£0.43m
5% cap	£2.50m	£0.33m
7% cap	£2.01m	£0.26m
10% cap	£1.50m	£0.19m

### Benefits to members from a cap

55. Members who wish to exit their current scheme early so they can access flexible retirement options, and who currently face an exit fee will potentially benefit depending on the level of the cap. Assuming schemes do not attempt to recoup this revenue by other means, the total benefit will be equal to the costs to business of the charges foregone. Therefore, the estimated total benefits to affected members in the first year will be £3.88m with a 2% cap, £3.30m with a 3% cap, £2.50m with a 5% cap, £2.01m with a 7% cap and £1.50m with a 10% cap. In subsequent years the costs are expected to be 13% of these at £0.51m for a 2% cap, £0.43m for a 3% cap, £0.33m for a 5% cap, £0.26m for a 7% cap and £0.19m for a 10% cap. This does not include any benefits of potential increased competition.
56. The assumption that businesses do not recoup the costs of the charges foregone is uncertain. The 2014 legacy audit review<sup>23</sup> looked into exit charges and suggested that they

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[https://www.abi.org.uk/~/\\_media/Files/Documents/Publications/Public/2014/Pensions/Defined%20contribution%20workplace%20pensions%20The%20audit%20of%20charges%20and%20benefits%20in%20legacy%20schemes.pdf](https://www.abi.org.uk/~/_media/Files/Documents/Publications/Public/2014/Pensions/Defined%20contribution%20workplace%20pensions%20The%20audit%20of%20charges%20and%20benefits%20in%20legacy%20schemes.pdf)

were often introduced as a means to recoup set-up costs. In schemes without exit charges this would likely be done either through a joining fee or just through the Annual Management Charge (AMC). There is an argument therefore about whether capping exit charges would indirectly lead to schemes increasing the AMC or discretionary payments for remaining members to compensate. If this were to occur it would be an indirect effect and has not been monetised in this impact assessment (either as lower costs to business or reduced benefits to members). However, there are reasons why this is less likely to occur:

- Any default arrangements in schemes that provide money purchase benefits and are used for Automatic Enrolment are subject to the existing charge cap which would limit the extent that the AMC could be used to recoup costs in these schemes.
- Market forces should dictate that if the provider increases the AMC, the trustees will move to another provider at the next opportunity to protect their members' interests.
- There is anecdotal evidence that some large providers have already started to eliminate early exit charges and are able to absorb the cost of doing so<sup>24</sup>.
- If there is evidence that pension schemes are increasing costs elsewhere in order to compensate for foregone exit charges the Government and regulators will take action to ensure that consumers are protected.

#### Administrative costs of implementing the cap

##### *Costs to implement the cap*

57. The amount of time it takes to administer the proposed cap would depend on a wide variety of factors, including:
- The number, scale and complexity of those amendments that might be required
  - The level of automation in how the charge is calculated and applied
  - The extent of literature updates needed
  - Whether contracts with providers need to be renegotiated
  - Whether or not the cap is expressed in similar operational metrics as those used by the firm to operate and calculate the charge.
58. Some firms may choose to implement upfront system changes to incorporate the cap, and will consider if this will be more cost-effective in the long-run than overriding the system on a case by case basis. Informal engagement with providers suggests that the costs involved in making system changes varies with some saying it is insignificant and others suggesting costs are much higher. As it will be for individual providers to determine how best to implement the cap, the costs of upfront system changes have not been considered here.
59. In addition, as the Government has already signalled the intention to introduce a cap on exit fees in contract-based pensions, the providers of these pensions will already face

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<sup>24</sup> We do not have evidence on whether any smaller providers are also voluntarily starting to reduce exit charges and will aim to test this during the consultation.

costs to implement the cap. If legislating for the same cap on trust-based schemes, providers which service both contract and trust-based schemes, will be able to align their systems rather than have different processes for trust-based schemes. This may create a saving compared to not introducing a cap on trust-based schemes. However, this will depend on the outcomes of the consultations.

- 60. However, for the purpose of this impact assessment, we have assumed that, at a minimum, businesses would continue using their existing systems and implement the cap by manually overriding the system.
- 61. The work involved in verifying that the exit charge has breached the cap is assumed to be 4 hours of a pension administrator’s time for every customer that is affected by the cap. This assumption is based on HMT discussions with industry and used in HMT’s impact assessment. We aim to test this assumption as part of the consultation process. The wage level of a pension administrator is assumed to be £19.10 per hour (including non-wage costs)<sup>25</sup> which gives a unit cost of £76.40 per override in 2014/15 prices.
- 62. Table 9 applies this unit cost to the number of members affected with each option to give total estimated costs in the first year, and each subsequent year. These are the total costs that would apply to insurance providers, administrators or the trustees depending how schemes are governed.

Table 9: Estimated implementation costs in first and subsequent years.

	Members benefiting in the first year	Costs to industry in the first year £m	Members benefiting in each subsequent years	Annual costs after the first year £m
2%	3,930	£0.31	510	£0.04
3%	3,030	£0.24	390	£0.03
5%	1,840	£0.14	240	£0.02
7%	1,220	£0.10	160	£0.01
10%	830	£0.07	110	£0.01

*Familiarisation costs*

- 63. There will be one-off costs to administrators, insurers or trustees of trust-based schemes to familiarise themselves with the rules of the change and check whether their scheme is in scope for the cap. As the Government has already signalled an intention to cap exit charges, the concept will be familiar to many in the pensions industry. However, the details of what is included in the cap and how it will work will need to be understood.
- 64. For schemes which don’t have exit fees this should be all that is required and is assumed to take around 1 hour<sup>26</sup> for a professional with a wage level of £24.77<sup>27</sup> giving a unit cost of around £24.77).

<sup>25</sup> This estimate is based on the assumption that pension’s administration is likely to be a higher wage paying profession than general administration. The estimate of £19.10 is based on the gross median hourly rate for an associate professional, which has then been increased by 27% in line with the Green Book to account for non-wage costs. The hourly rate data is in 2014 prices and taken from the most recent available ASHE, 2015: <http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2015-provisional-results/rft-2.zip>

<sup>26</sup> This assumption is based on reading and digesting at least 12 pages of regulatory guidance based on average reading speeds.

65. For schemes that have exit fees, and for the administrators and insurers that service schemes with exit fees, then the familiarisation will be more substantial as we assume they will also need to incorporate (i) a one-off task for a compliance officer to construct a method to override the system and sets out the steps needed in an operational guide, and (ii) time for training for operational staff to learn the required manual override method. Based on HMT calculations and assumptions<sup>28</sup>, we assume it takes the compliance officer at each affected business 24 hours at an hourly wage level of £24.77 to complete the familiarisation. In addition, it is assumed that 10 operational staff will take 2 hours each to complete the training with an hourly wage of £19.10<sup>29</sup>. This gives a total unit cost of £976 per business.
66. TPR have previously advised that just over 200 unique insurers, administrators and Master Trusts provide services to the vast majority of DC schemes<sup>30</sup>. It is assumed that all of these service at least one scheme which levies exit charges so the unit cost of £976 will apply.
67. This leaves around 260 unbundled DC schemes which are either self-administered or have no administrator recorded by TPR where the trustee (or the sponsoring employer) would need to do the familiarisation themselves. Of these, around 4% are assumed to apply exit charges (based on the latest TPR evidence<sup>31</sup>) and a £976 unit cost is applied. For the remaining 96% the basic unit cost of £24.77 will apply.
68. In addition there are 880 dual-section hybrid schemes with 12 or more members for which we do not have any information on the governance so assume, at a maximum, the a trustee from each of these would need to familiarise themselves with the rules. Again we assume 4% of these will face a unit cost of £976 and 96% will face a unit cost of £24.77.
69. This gives familiarisation costs of £248,000 for the businesses and schemes where exit charges apply, and £27,000 for schemes which do not levy exit charges with a total of £275,000 in 2014/15 prices. When uprated to be in 2015/16 terms the total estimated familiarisation costs are £280,000.

#### *Familiarisation costs for micro-schemes*

70. Micro-schemes, which have between 2 and 11 members, account for 92% of the total trust-based market, but only 1% of total trust-based membership<sup>32</sup>. These are not specifically included in the number of businesses calculated above to estimate the familiarisation costs. However, the vast majority of micro schemes, including EPPs, will be

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<sup>27</sup> The estimate of £24.77 is based on the gross median hourly rate for a professional, increased by 27% in line with the Green Book to account for non-wage costs. It is assumed that for a single professional employee would undertake this work. The hourly rate data is in 2014/15 prices and taken from the Annual Survey of Hours and Earnings (ASHE), 2015: <http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2015-provisional-results/rft-2.zip>.

<sup>28</sup> HMT Impact Assessment on introducing an exit charge cap for contract-based schemes

<sup>29</sup> This estimate is based on the assumption that pension's administration is likely to be a higher wage paying profession than general administration. The estimate of £19.10 is based on the gross median hourly rate for an associate professional, which has then been increased by 27% in line with the Green Book to account for non-wage costs. The hourly rate data is in 2014/15 prices and taken from the most recent available ASHE, 2015: <http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2015-provisional-results/rft-2.zip>

<sup>30</sup> These figures have previously been used in the DWP Risk Warnings Impact Assessment, March 2016

<sup>31</sup> Findings to be published in due course

<sup>32</sup> DC trust: a presentation of scheme return data 2015-2016, TPR



in bundled arrangements and use an insurance provider already included above. For example, over 80% of micro schemes (where the split is known) are small relevant schemes and over half of these are known to use one of the 10 largest providers<sup>33</sup>. It is highly likely that the remaining micro-schemes will either use an administrator or smaller insurance provider and, therefore, we do not expect the trustees of micro-schemes to be directly affected by the changes, and the associated administrators or providers will already be included in the volumes above.

71. However, even if the trustees do self-administer the scheme, the nature of the familiarisation required will be negligible, and at a minimum, the trustees will only need to familiarise themselves with the requirements on the rare occasion that a member wants to leave the scheme before the selected retirement age and an exit charge above the cap applies. Given the small number of members potentially affected, it is unlikely that work to construct an override upfront will be required and would likely form part of usual business. Therefore we do not expect micro-schemes to be adversely affected<sup>34</sup>.

## **Risks and Assumptions**

72. The evidence used for this Impact Assessment predominantly comes from FCA and TPR surveys on exit charges. There is inherent uncertainty in the results from any survey where it is based on a sample of the population but these surveys achieved good coverage with 94% and 87% of members covered in the September FCA and TPR surveys respectively. Although the sample sizes are relatively small for trust-based schemes with exit charges, the results from the most recent TPR survey are reasonably consistent with the first.
73. There is some uncertainty around the processes and costs involved in implementing the cap because of the wide variation in how exit charges are applied. We will look to gather more evidence on this during the consultation. If evidence emerges to contradict our current assumptions we will revisit the analysis at final stage.

## **Direct costs and benefits to business (OI30)**

74. The equivalised annual net direct costs to business are estimated at £0.9m for a 2% cap, £0.8m for a 3% cap, £0.6m for a 5% cap, £0.5m for a 7% cap and £0.4m for a 10% cap. These are assessed over a 10 year period from 2017.

## **Wider impacts**

### *Indirect impacts on consumers*

75. There would be benefits to individuals from being able to choose the best possible option for using their retirement savings, rather than being constrained due to exit charges acting as barriers. For example, if individuals are withdrawing their pensions to pay off debts, it is likely to cause a quantifiable monetary benefit to the individuals concerned as the interest on debts are often higher than the interest accrued on pensions.

### *Impact on competition*

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<sup>33</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/298436/better-workplace-pensions-march-2014.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf)

<sup>34</sup> This is in line with assumptions made for similar regulatory changes, such as the requirement to signpost members to Pension Wise.

76. It is possible that by reducing exit charges and limiting the extent to which providers and administrators recoup set-up and commission costs, providers will be more selective in the schemes they take on, with fewer providers willing to provide for schemes where there is high turnover of staff. This may create more consolidation of the market in the future with fewer, larger providers.
77. However, by removing excessive early exit charges customers will be able to freely choose between different providers and access the full range of flexibilities at a reasonable cost, instead of effectively being forced to stay with their existing provider. This greater customer mobility could have competition benefits by enabling customers to move to providers and products that best suit their needs.

### **Small and Micro Business Assessment**

78. The pension providers and administrators affected are typically large businesses servicing a number of schemes, including micro-schemes, although there will be a minority of smaller businesses also. However, even where small and micro-schemes are self-administered the number of members affected by the changes will be very small indeed and the work required to cap the relevant charges is not likely to be a separate, one-off task but instead will be part of their usual business. Therefore we do not expect any micro-schemes to be adversely affected.
79. The primary objective of the policy is to allow all customers to access the new pension flexibilities easily, and at a reasonable cost. Exempting any subset of pension providers from the proposed cap would potentially leave some customers with significant levels of early exit charges that would discourage them from accessing the new pension flexibilities. Therefore, granting small and micro businesses a full exemption from the proposed cap would not be compatible with the aims of the policy.
80. If evidence emerges as part of the consultation that the cap would have a disproportionate impact on small and micro-businesses, the Government would expect to take steps to mitigate these impacts.

### **Implementation of preferred options**

81. The Government intends to bring forward legislation at the earliest opportunity to cap excessive early exit fees to ensure that members of trust-based schemes have the same protection as those in contract-based schemes. The exact level of the cap will be determined after the consultation. In terms of timing the intention is to introduce the cap in Spring/Summer 2017.

## ANNEX – Calculation of average exit charges paid

To estimate the level of charges that would be foregone with a cap we need to first calculate the average charge paid without a cap. This is calculated from FCA data on the distribution of exit charges<sup>35</sup>.

Table A1 shows the number of contract-based policies held by customers aged 55 or older facing flat fee exit charges from the FCA sample<sup>36</sup>. We have assumed that the midpoint or median average is equal to the mean average value of all charges within each band and that there is no skewed distribution in the FCA data. Furthermore, we have assumed that £7,500 is the mean of all charges in the sample that is over £5,000. These averages are then multiplied by the estimated caseload to calculate the total amount of potential exit charges in the FCA sample at £461.5 million.

Table A1 – Number of contract-based policies held by customers aged 55 and above incurring exit charges (by cash charge £)

Size of charge	Average fee (A)	Number of pots (B)	Total amount of exit charges in the sample (A x B)
£0	£0	3,416,000	£0
£0-£250	£125	375,000	£46,875,000
£250-£500	£375	103,000	£38,625,000
£500-£1000	£750	86,000	£64,500,000
£1000-£3000	£2,000	77,000	£154,000,000
£3000-£5000	£4,000	15,000	£60,000,000
>£5000	£7,500	13,000	£97,500,000
Total		4,086,000	£461,500,000

In addition, the FCA also collected data on the percentage size of the exit charges from the firms in the sample. Table A2 shows the exit charges as a percentage of the fund value in the data. We have again assumed that the midpoint represents the mean value of all charges within each band. In addition, we have assumed that 50% is the mean of all charges in the sample that is over 40%.

As we have previously calculated the total amount of exit charges in the sample to be £461.5m, this allows us to use an iterative method to calculate the mean pot size in the sample. By starting with an estimate of the mean pot size, we can multiply the mean pot size by the midpoint of each band of the table to calculate the mean cash value of the percentage exit charges in each band. By multiplying the mean exit charges of each band by the number of pots in each band, we are then able to find the total value of exit charges in each band in the sample. By applying this iterative method, we have calculated the illustrative mean pot size in the sample to be £16,760. Using this information, we can calculate the total cost of capping exit charges at different percentage rates.

<sup>35</sup> FCA Pension freedoms data collection exercise: analysis and findings, September 2015

<sup>36</sup> HMT analysis of FCA data collection exercise results from September 2015

Table A2 – Number of contract-based policies held by customers aged 55 or above incurring exit charges (as % of fund value)

Charge %	Mean exit charge in this band (A)	Number of pots (B)	% of pots (C)	Total amount of exit charges in the sample (A x B)
0	£0.00	3,416,000	84%	£0
0-1	£83.80	243,000	6%	£20,363,991
1-2	£251.41	116,000	3%	£29,163,247
2-3	£419.01	71,000	2%	£29,749,864
3-4	£586.62	54,000	1%	£31,677,320
4-5	£754.22	40,000	1%	£30,168,876
5-6	£921.83	35,000	1%	£32,263,937
6-7	£1,089.43	14,000	0%	£15,252,043
7-8	£1,257.04	12,000	0%	£15,084,438
8-9	£1,424.64	10,000	0%	£14,246,414
9-10	£1,592.25	9,000	0%	£14,330,216
10-15	£2,095.06	26,000	1%	£54,471,582
15-20	£2,933.09	19,000	0%	£55,728,618
20-40	£5,028.15	17,000	0%	£85,478,482
40+	£8,380.24	4,000	0%	£33,520,973
Total		4,086,000	100%	£461,500,000

The mean exit charges calculated in Table A2 can then be used as a proxy for the mean exit charges faced by members of trust-based pensions.