

**EXPLANATORY MEMORANDUM TO
THE OCCUPATIONAL PENSION SCHEMES (CHARGES AND GOVERNANCE)
REGULATIONS 2015**

2015 No. [XXXX]

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.
2. **Purpose of the instrument**
 - 2.1 This instrument sets out a range of measures aimed at protecting members of occupational pension schemes which offer money purchase benefits. In particular it sets out what actions trustees and managers of these schemes must take in respect of charges and governance matters concerning these schemes.
3. **Matters of special interest to the Joint Committee on Statutory Instruments**
 - 3.1 None
4. **Legislative Context**
 - 4.1 As the Government moves towards its goal of around 10 million workers saving into workplace pensions, there is a need to make sure those pension savings are invested in schemes that are well governed and that members are protected from high or unfair charges. These draft Regulations seek to protect members of certain occupational pension schemes by imposing obligations on trustees and managers in relation to charges imposed on certain members of those schemes and how those schemes are governed.
5. **Territorial Extent and Application**
 - 5.1 This instrument applies to Great Britain. The Department for Social Development in Northern Ireland will be producing corresponding legislation for Northern Ireland.
6. **European Convention on Human Rights**
 - 6.1 The Minister of State for Pensions, the Rt.Hon. Steve Webb MP has made the following statement regarding Human Rights, ‘in my view the provisions of the Occupational Pension Schemes (Charges and Governance) Regulations 2015 are compatible with the Convention rights’.
7. **Policy background**

What is being done and why

 - 7.1 By 2018, it is estimated that 8 to 9 million people will start saving into a pension, or be saving more as a result of automatic enrolment. It is therefore critical that workplace pensions should be well governed and members protected from high and

unfair charges. The Office of Fair Trading's 2013 study¹ of the defined contribution workplace pensions market concluded that there were significant weaknesses that prevented competition working in the interests of consumers.

- 7.2 These Regulations cover a range of measures aimed at controlling the level and range of charges in pension schemes which are used by employers to meet their automatic enrolment duties ('qualifying schemes'). These include capping charges in the default arrangements within these schemes (broadly speaking, arrangements into which members are contributing without making an active choice or which have a minimum percentage of workers contributing) at 0.75 per cent annually of funds under management, or an equivalent combination charge from April 2015.
- 7.3 The Regulations also impose a ban on Active Member Discounts (AMDs) from April 2016. These are charge structures where the charge imposed on a member is increased when they stop contributing to the scheme, for instance because they leave their employment.
- 7.4 These Regulations also apply new governance measures across broadly all occupational pension schemes which offer money purchase benefits.
- 7.5 The Regulations also give enforcement powers to The Pensions Regulator in respect of the charges and governance measures.
- 7.6 There are two main types of workplace pension – occupational schemes and workplace personal pensions. These Regulations apply to certain occupational schemes which provide money purchase benefits. The firms that provide workplace personal pensions are regulated by the Financial Conduct Authority (FCA). The FCA is making equivalent rules relating to governance and charges for workplace personal pension schemes (subject to certain exceptions). These rules come into effect from 6 April 2015.

Scope

- 7.7 The charges measures apply to those occupational schemes offering money purchase benefits which are used by employers to meet their duties under automatic enrolment ('qualifying schemes'). The governance measures have a broader scope, and cover occupational schemes offering money purchase benefits, regardless of whether they are being used for automatic enrolment.
- 7.8 Broadly speaking, 'money purchase benefits' are benefits where the rate or amount of the benefit is based on the member's contributions and investment returns, less charges. In these cases there is no promise which could create a deficit in the scheme. The definition of money purchase benefits is set out in section 181 and 181B of the Pension Schemes Act 1993 as modified by section 29 of the Pensions Act 2011.
- 7.9 Some schemes are not covered by either the governance or charges measures. These include small self-administered schemes and executive pension schemes². In

¹ <http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/OFTwork/markets-work/pensions/>

these cases we expect there to be a higher level of member engagement so legislative protections are less necessary. In addition, certain public service pension schemes, and those schemes providing no money purchase benefits other than those attributable to Additional Voluntary Contributions, are not covered by the governance measures.

- 7.10 Stakeholder pension schemes are subject to the governance provisions. They are also subject to the charges measures when they are used as qualifying schemes.

Charges

- 7.11 These Regulations set out measures to restrict charges in relevant occupational pension schemes, where these are used by employers to meet their automatic enrolment duties ('qualifying schemes'). The duties under the Regulations fall on trustees and managers.
- 7.12 The Regulations cap the level of charges that can be charged to members of the scheme's 'default arrangement'. The charge cap is intended to protect those savers who have had little or no engagement with their pension savings which is why it applies to default arrangements. A default arrangement generally means the investments that are selected automatically for a member joining a pension scheme, unless that member selects an alternative investment strategy.
- 7.13 The Regulations include 3 tests by which trustees and managers may identify the default arrangements within their schemes. The first test defines a default arrangement as the investment fund, or group of funds, which members' contributions are directed into if they do not make an active choice about their investments.
- 7.14 Some schemes do not have an arrangement which meets this description, because members are, or were, required to choose the investment fund or arrangement they would contribute to. The second and third tests therefore aim to capture those arrangements that have been, or are, used in a similar way to a 'true' default. These are relevant to those schemes that require, or have required, members to make a choice about where their contributions are invested. The second test is satisfied where 80 per cent or more of these members are invested in a particular arrangement at the point at which the charge cap first applies (either 6 April 2015, or when the employer's automatic enrolment duties start applying if this is later than that date).
- 7.15 The third test is intended to cover the situation where joining a pension scheme is part of an employee's contract of employment after 6 April 2015 (or when the employer's automatic enrolment duties first apply, if later). It is satisfied where an arrangement first receives contributions after 6 April and into which 80 per cent or more of members are contributing.
- 7.16 The Regulations also specify that once an arrangement satisfies the definition of a 'default arrangement', it will always be a default arrangement. This means that all

² Where a company is both the only employer in relation to the scheme and the sole trustee, and the members of the scheme are either current or former directors of that company and include at least one-third of the current directors.

members of that arrangement will continue to be covered by the charge cap as long as they remain invested in the default.

- 7.17 The Regulations also specify that once an arrangement is used as default, it will always be a default arrangement. This means that all members of the default arrangement who are or have been employees of the employer subject to the cap will continue to be covered by the charge cap as long as they remain invested in the default.
- 7.18 The charge cap applies from 6 April 2015, or from the date at which the scheme is used by an employer for automatic enrolment, if this is later. Members who make a contribution to the default arrangement on or after that date will be protected by the cap. The cap applies to all the member's funds invested in the default arrangement, irrespective of when those contributions were made.
- 7.19 The cap introduced by the Regulations is set at 0.75 per cent annually of funds under management, or an equivalent combination charge. The measures restrict the charging structures which schemes may use in their default arrangement. There are three permitted options – the first of these is a charge that is calculated as a percentage of the size of the member's pension pot ('funds under management charge'). The second of these is a combination of a funds under management charge and a charge that is calculated as a percentage of the contributions paid into the scheme by, or on behalf of the member ('contribution charge'). The third of these is a combination of a funds under management charge and a flat-fee charged to the member. The measures also prevent trustees and managers from switching between these three charge structures within a charges year.
- 7.20 The charge cap covers all costs and charges relating to general scheme administration and investment administration. For instance, this includes charges for transfers in and out of the scheme. 'Transaction costs' are excluded from the charge cap. Transaction costs are defined as costs that a scheme incurs as a result of buying, selling, lending and borrowing investments. A small number of other costs do not come under the charge cap. These are the costs associated with complying with court orders, pension sharing on divorce cases, winding up a scheme, and costs solely associated with the provision of death benefits.
- 7.21 Trustees and managers will be able to charge in excess of the cap for services which the member has agreed to, subject to a number of safeguards, including that this agreement must be in writing and include a statement to the effect that it will result in charges that exceed the level of the cap.
- 7.22 The Regulations provide two methodologies by which trustees and managers may measure whether charges in their default arrangements have complied with the charge cap. They may decide which of these methodologies to use, depending on how they levy charges on members.
- 7.23 The charge cap was not designed to cover arrangements which include a promise to the member about the benefits they will receive. For example, some arrangements may include a promise about a rate of income or a lump sum or about factors such as minimum investment returns. Benefits which include a promise will not generally meet the definition of 'money purchase benefits' so will not be caught by the charge cap. However, in some cases the funding liability for a promise is borne by a third party outside of the scheme or provider, for instance an insurer. In these

cases, the benefits may be money purchase benefits. As the charge cap was not designed with these promises in mind, money purchase arrangements which offer a third party promise are not subject to the cap. This also ensures parity of treatment between benefits where the funding liability for the promise is borne by the scheme (in which case they are not money purchase and excluded from the cap), and those where the funding liability is held by a third party (which in contrast are money purchase).

- 7.24 The Regulations also provide for Active Member Discounts to be banned from qualifying schemes from April 2016. AMDs may remain in place between April 2015 and April 2016. However, the charge cap itself will still apply to members in the default arrangement who stop contributing during that period. The measures do not ban employers from subsidising the charges of contributing members, or prevent trustees or managers charging members at different rates, as long as the total level of charges imposed on a member who has stopped making contributions is no higher than it would be if they were contributing.

Minimum Governance Standards

- 7.25 The Regulations set out minimum governance standards for relevant occupational pension schemes. They require that trustees and managers of these schemes ensure that default arrangements are designed in members' interests and kept under regular review, that core financial transactions are processed promptly and accurately and that trustees and managers assess the value of charges and transaction costs borne by scheme members.
- 7.26 They also require that trustees and scheme managers must appoint a Chair (where the scheme does not already have a Chair in place). The Chair will be responsible for signing off an annual Chair's Statement on how these minimum governance standards have been met. This statement will be included in the scheme annual report and will therefore be made available to members and other prescribed persons on request along with the annual report.
- 7.27 The Regulations also provide for additional requirements to strengthen the independent oversight of schemes used by multiple employers. These schemes are defined in the Regulations as multi-employer schemes where some or more of the employers are not part of the same corporate group.
- 7.28 These schemes must have a minimum of three trustees. The majority of these trustees, including the Chair, must be independent of anyone who provides services – such as advisory, administration or investment services – to the scheme. The Regulations require that these independent trustees must be subject to limited term appointments of up to five years with a ten year cumulative total. There must also be an open and transparent appointment process for recruiting independent trustees.
- 7.29 Where trustees are independent professional trustee firms, the requirement for limited term appointments applies but instead of a ten year cumulative total the individual representing the firm must be changed every ten years. The Regulations set out a definition of “professional trustee body”.
- 7.30 In some cases the trustee board governing a scheme is a corporate entity. In these cases, the same requirements about minimum numbers of trustees, independent

trustees, limited term appointments, and open and transparent recruitment apply to the trustee directors of the trustee.

- 7.31 The Regulations also require trustee boards to encourage members to make their views known on matters relating to the scheme.
- 7.32 The Regulations introduce a temporary exemption for schemes set up under statute as these schemes generally have robust governance arrangements in place. We will be reviewing this exemption over the course of 2015. They also exempt the National Employment Savings Trust (NEST) from these requirements as there are already existing statutory requirements concerning how it is governed.

Compliance

- 7.33 These Regulations also give enforcement powers to The Pensions Regulator. Schemes are required to provide an annual scheme return to The Pensions Regulator. This annual scheme return notice will incorporate three additional questions, which will be used to identify the Chair of the trustees, gather information on the completion of the Chair's Statement and confirm compliance with the charges and quality measures.
- 7.34 In the case of non-compliance with the requirement to prepare a Chair's Statement, these Regulations require The Pensions Regulator to issue a fine against the Board of trustees or managers, including officers of corporate trustees.
- 7.35 These Regulations also give The Pensions Regulator the power to issue compliance and penalty notices to both trustees / managers and third parties.
- 7.36 Penalty notices can be issued to trustees / managers, and also to officers of a body corporate where the trustee is a corporate trustee, on a joint and several liability basis to ensure that liability for a financial burden is not borne unequally between the persons to whom it is issued. However, we did not consider that compliance notices needed to be issued on a joint and several basis, since there the focus is on the action of the trustees / managers as a whole (as opposed to individual liability)
- 7.37 Regulation 31 of the draft Regulations (review of penalty notices) and regulation 32 (references to the Tribunal) both give important safeguards to members to ensure that trustees are and continue to act in their best interests.
- 7.38 Default arrangements in occupational schemes used as qualifying schemes should be compliant with the charge cap from 6 April 2015. If from that date, trustees or managers identify that they are unlikely to be able to ensure compliance in that 'charges year' (a 12 month period, as defined in the Regulations) or the next, then these Regulations set out an adjustment measure to allow them to close the arrangement or scheme to future contributions. This measure is available only between April 2015 and October 2015. A similar measure is also available indefinitely for exceptional events which are outside the control of trustees or managers.
- 7.39 In either case, under this measure trustees must have used their best endeavours to comply with the charge cap, and must direct future contributions to a compliant arrangement within their scheme, or inform the sponsoring employer(s) that they must find an alternative qualifying scheme to meet their automatic enrolment duties

under the Pensions Act 2008. The previous default arrangement(s) would not be subject to the cap from the date at which contributions to that arrangement cease.

Consolidation

7.40 Informal consolidated text of instruments is available to the public free of charge via ‘The Law Relating to Social Security’ (Blue Volumes) on the Department for Work and Pensions website at <http://www.dwp.gov.uk/publications/specialist-guides/law-volumes/the-law-relating-to-social-security/> or the National Archive website [legislation.gov.uk](http://www.legislation.gov.uk).

8. Consultation outcome

8.1 Following publication of the Office of Fair Trading’s interim findings, the Government issued a call for evidence on the issue of scheme quality in summer 2013. This was followed in October 2013, by a public consultation, “Better workplace pensions: a consultation on charging”³. This brought forward proposals to address the OFT’s concerns that competition alone could not be relied upon to ensure value for money for all savers through a range of charge controls, including a charge cap, and disclosure requirements.

8.2 In March 2014, in the Command Paper “Better Workplace Pensions: Further measures for savers”⁴ the Government set out a range of measures to help ensure schemes are governed in members’ interests. Firstly, it confirmed its intention to introduce a cap on scheme and investment administration charges in default arrangements and a ban on various charges that are inappropriate in the context of automatic enrolment into workplace pensions, namely consultancy charging, adviser commission and active member discounts.

8.3 Secondly, this paper also consulted on proposals to introduce minimum governance standards across workplace pension schemes and announced the Government’s intention to bring forward a range of measures to improve transparency of all costs and charges in workplace schemes.

8.4 This was followed in October 2014 by the Command Paper “Better Workplace Pensions: Putting savers’ interests first”⁵ in which the Government confirmed its plans to introduce these new measures on governance and outlined further detail about how the charges measures would be implemented. It also launched a consultation on draft regulations which ran for 4 weeks ending on the 14 November 2014, to introduce these measures for occupational pension schemes. The Financial Conduct Authority (FCA) has consulted on making equivalent rules for workplace personal pension schemes.

8.5 We received 52 written responses from pensions industry representatives, consumer representatives, trades unions, legal firms, trustees and employers. During the

³ <https://www.gov.uk/government/consultations/better-workplace-pensions-a-consultation-on-charging>

⁴ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

⁵ <https://www.gov.uk/government/consultations/better-workplace-pensions-putting-savers-interests-first>

consultation period the Department held a number of stakeholder meetings to discuss the draft regulations.

- 8.6 We have had a wide variety of views from a broad range of sources, and that input has enhanced the policy and regulation making process.
- 8.7 A small number of changes to the regulations were made following consultation. These include:
- provision for Chair's statements covering a period of less than 3 months;
 - a temporary exemption from the multi-employer scheme independence requirements for schemes set up under statute;
 - excluding single member schemes from the charges measures;
 - excluding costs solely related to death benefits from the default arrangement cap;
 - providing a supplementary method by which trustees and managers may assess charges and more flexibility on the annual cycle over which this takes place; and
 - excluding Additional Voluntary Contributions from the test which is carried out to identify defaults where members were required to make an active choice.
- 8.8 On compliance most respondents agreed that the proposals were sensible and proportionate.
- 8.9 The Government response to this consultation, can be found at: <https://www.gov.uk/government/consultations/better-workplace-pensions-putting-savers-interests-first>

9. Guidance

- 9.1 The Pensions Regulator guidance and Codes of Practice will be updated to reflect these changes in due course.⁶
- 9.2 The Pensions Regulator will be publishing short essential guidance to correspond with the Regulations coming into force.

10. Impact

- 10.1 The Regulations have an impact on trustees and managers of workplace pension schemes and scheme members. The net cost to business per year is estimated to be £23.85m (£18.8m due to the measures relating to charge controls and £5.05m due to minimum governance standards). These Regulations produce significant, benefits to individual scheme members. The introduction of a charge cap on the default arrangement of qualifying schemes is estimated to benefit individuals by £195m in 2013/14 prices over a ten year period. The other measures should lead to better value for money, higher private savings levels and higher retirement incomes for individuals. It has not been possible to fully quantify the impact of all these measures on individual savers.
- 10.2 The impact on the public sector is minimal and arises from the need to ensure that members of occupational pension schemes are included in charges and governance measures.

⁶ www.thepensionsregulator.gov.uk/doc-library/guidance.aspx

- 10.3 Separate impact assessments for charges and minimum governance standards have been produced and will be re-published alongside this Explanatory Memorandum on www.legislation.gov.uk.

11. Regulating small business

- 11.1 A Small and Micro Business Assessment has been included in each impact assessment. There is a clear consensus that all pension scheme members should be enrolled into well governed schemes offering value for money, regardless of its size.
- 11.2 Around 40 per cent of employees work for small and micro employers. Employers of all sizes have a choice about whether to establish their own Defined Contribution (DC) trust scheme, or use a contract-based scheme or master trust for their employees. We expect the majority of small and micro employers who do not currently have a scheme to use a master trust or contract-based scheme for automatic enrolment, rather than establishing their own DC trust-based scheme. Where a small or micro employer has chosen to operate a single employer DC trust-based scheme for their employees, then the scheme will be required to meet the new requirements. At the pension provider level, the market is already very concentrated. There is no correlation between small pension schemes and small pension providers. Information from The Pensions Regulator shows that although there are some 1,790 small DC trust-based schemes (12-99 members); over two-thirds are operated by just 10 of the largest providers, accounting for over 65 per cent of the total small scheme membership.
- 11.3 We did not think that the inclusion of a sunset provision was appropriate as it would create more uncertainty for savers and go against the Government's intention to encourage savings and ensure members savings aren't eroded by charges. We also feel it is important to ensure transparency and build confidence in investment returns for members.

12. Monitoring & review

- 12.1 There is no planned evaluation of the policy as reflected in this Statutory Instrument except for a temporary exemption mentioned at paragraph 7:32 of this document which we will be reviewing over the course of 2015.
- 12.2 In 2017, the Government and regulators will conduct a post-implementation review of all these measures to assess their effectiveness in protecting savers from high and unfair charges, improving governance in members' interests and increasing transparency of costs and charges throughout the value chain. In particular, the review will consider the level of the charge cap and whether this remains appropriate, or should be changed, and whether to include some or all transaction costs within the cap.

13. Contact

- 13.1 Polly Fortune at the Department for Work and Pensions Tel: 0207 245 3831 or email polly.fortune@dwp.gsi.gov.uk can answer any queries regarding the instrument.