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The impact of DC regulation on employer scheme choice

Introduction

This Briefing Note reflects some of the findings from a research report on the regulation of Defined Contribution (DC) pensions, conducted by the PPI on behalf of Scottish Widows.

Under automatic enrolment, employers are required to select a pension scheme and make contributions for their employees. While some employers have an existing pension scheme that can be used for this purpose, others will need to set up a new scheme or select a pension scheme from those operated by organisations such as insurers and employee benefits consultants.

Typically employers have used either contract-based pensions, such as Group Personal Pensions (GPPs), or trust-based ones, such as Master Trusts, for automatic enrolment. Differences in the arrangements of these pensions, and in how they are regulated mean that an employer's choice could have implications for employees' outcomes.

This Briefing Note provides an overview of GPPs and Master Trusts and considers the different regulatory regimes in which they operate, including a high level assessment of their relative strengths. The Note goes on to outline some of the considerations that employers need to take into account when selecting a pension scheme for automatic enrolment.

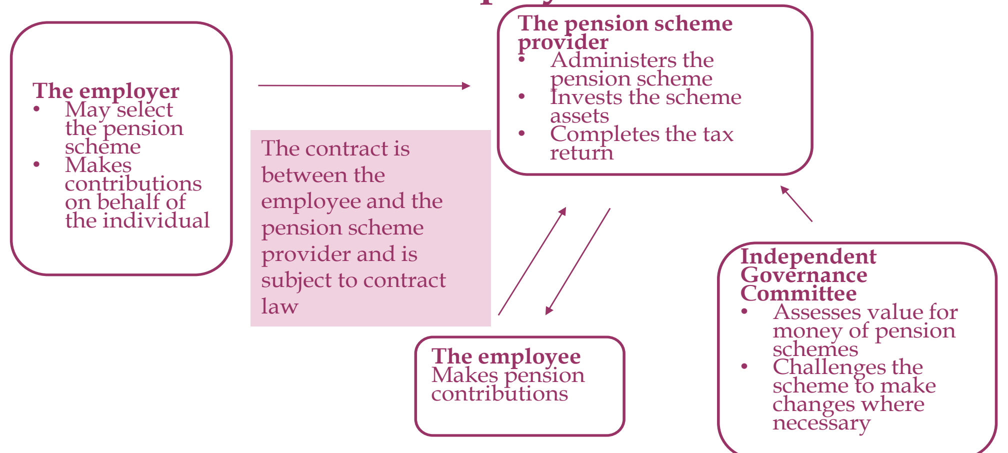
Types of pension scheme

Pension schemes used by employers are either trust or contract-based. These arrangements are supported by different legal underpinnings which, in turn, have influenced the types of regimes that regulate them.

Contract-based schemes. Under contract-based arrangements (Chart 1), the employer selects the pension scheme but the contract is between the employee and the pension provider, usually an insurance company. Such schemes are subject to contract law, which covers areas such as unfair conditions and compensation for losses. These pensions may be purchased by an individual or organised by their employer.

Independent Governance Committees (IGCs) have recently been introduced as an additional layer of protection for members of workplace contract-based pension schemes. These Committees are independent of the pension provider and their remit is to ensure that schemes act in the best interest of members and challenge providers if they are not providing value for money to members.

Trust-based schemes. There is no contract between the pension provider and the employee for trust-based schemes. Rather, the



PPI Briefing Notes clarify topical issues in pensions policy.

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employer appoints trustees to hold a scheme's assets on trust, with the scheme being governed by the trust deed and rules (Chart 2). Trustees are required to act impartially in the interests of the scheme members and to protect the assets from intervention by an employer.

From April 2015, both IGCs and trustees are required to assess 'value for money' in their Defined Contribution (DC) pensions. This topic is explored in more detail later in this Note.

Another option is a single-trust based pension, where the employer sets up a trust-based pension solely for their employees. Single trust-based pensions may represent an opportunity for employers who wish to play a central role in their workforce's accumulation of pension assets. In reality, few employers select this option due to the burden of appointing trustees and, in turn, the high level of responsibility borne by the trustees. In contrast to single trust-based pensions, both GPPs and Master Trusts generally cost less and require lower levels of employer involvement.

This reality is reflected in the figures for schemes used for automatic enrolment; to date, 51% of DC pension schemes used for automatic enrolment have been Master Trusts and 46% have been GPPs. 3% have been other DC trust-based pensions.[1] The remainder of this note, therefore, focuses on GPPs and Master Trusts.

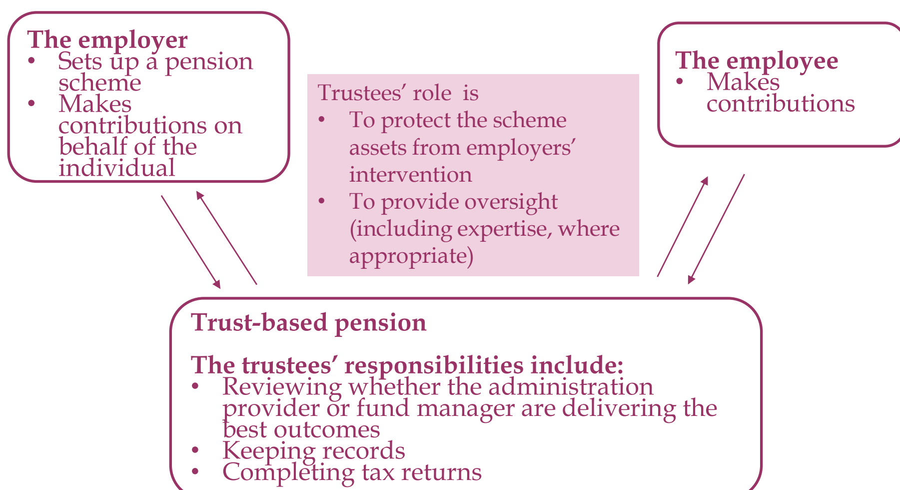
Trust and contract-based pensions are regulated by different bodies

Organisations that provide contract-based pension schemes are regulated by the Financial Conduct Authority (FCA). Those providing trust-based pensions are regulated by The Pensions Regulator (TPR). Employers are also regulated by TPR, who ensures that they make pension contributions for their employees, as required under the automatic enrolment rules, regardless of the type of pension selected. TPR provides a 'Duties Checker' that helps employers to understand what they are required to do.[2]

Chart 3 shows the different regulatory regimes for trust and contract-based pensions. The FCA sits within Her Majesty's Treasury's remit while TPR answers to the Department for Work and Pensions. Providers of both type of pension schemes can be authorised by Her Majesty's Revenue and Customs (HMRC) to give tax relief on pension payments at source.

The regulators of Master Trusts and GPPs have different strengths

Research conducted by the PPI found that, overall, TPR's strengths lie in its pragmatic approach.[3] This makes it relatively straight-forward for trustees and employers to comply with the regulations, and the legislation allows pension schemes leeway in terms of their communications with members.



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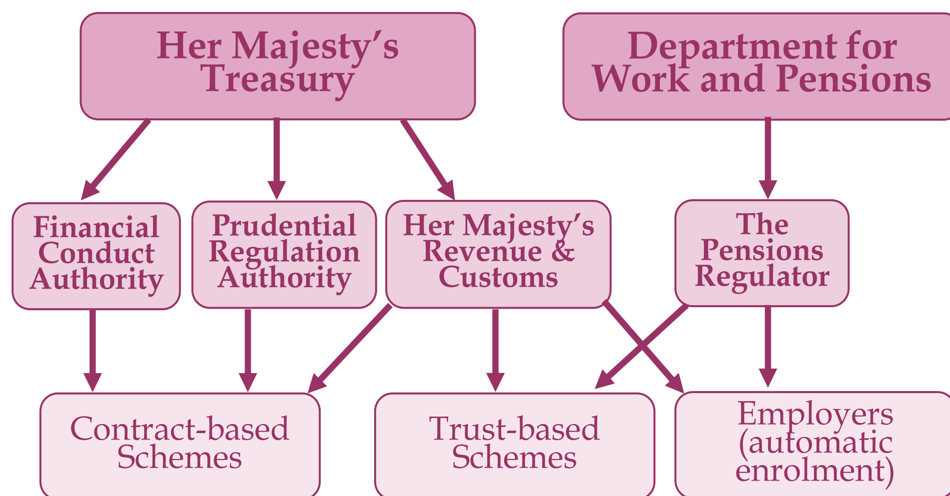

The FCA's regime is considered by those in the industry to be comparatively more rigorous and designed to prevent adverse events. In particular the FCA threshold conditions around areas such as having adequate resources and knowledge, are more stringent for providers of GPPs. Such providers have to demonstrate that they have met these conditions before they can provide financial services. Further, the FCA regime includes supervision requiring ongoing engagement with the GPP provider. In this way, the FCA regime is pro-active in looking to prevent adverse events rather than identifying these when they have already occurred.

In contrast, a Master Trust can be set up with three trustees, provided that the majority are independent of the scheme provider.

While the FCA regime is considered relatively rigorous, it has been designed for customers making retail purchases of financial services products. As members of workplace pensions do not make the product selection, written communications for GPPs can include unnecessary content, making them overly complex.

Overall, the trust-based regime alongside TPR's pragmatic approach can encourage and enable trustees to develop excellent governance structures. However, in contrast with the more proactive FCA regime, this approach requires trustees and whistle-blowers to identify risks and adverse events. This may happen only after the adverse event has occurred. It also depends on whether the experience, intentions and composition of trustees mean that they are equipped to take action where necessary.

For this reason, employers may wish to assess the quality of the Master Trust. They may wish to make their own enquiries or may be happy to accept industry standards such as the Master Trust Assurance Framework. Information is available on the TPR website (a link to this is included in the footnotes).[4]

In contrast, the checks in the FCA's regime are well-suited to avoiding pension member detriment.

The Financial Services Compensation Scheme (FSCS) can pay compensation to consumers when an authorised financial services firm is unable, or likely to be unable, to satisfy claims against it, due to its financial position. There are a number of conditions that must be met for the FSCS to be able to pay compensation.[5]

Specific considerations for employers

Chart 4 provides a comparison between GPPs and Master Trusts, exploring some distinct differences between them.

There are other characteristics, such as charges, explored in more detail later in this Note.

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Chart 4: Employer's choice of Master Trust or GPP

Criteria	Master Trust	GPP
Employers' objectives for pension provision	May be more suitable for employers who do not expect their employees to exercise choice around their pension scheme.	May be more suitable for employers who would like their workers to take responsibility for their pension savings. As individuals receive more tailored information as they approach retirement, this regime may help those individuals to make choices about the management of their savings.
Governance structures	Rules provide for Master Trusts to aspire to excellent governance structures. However, this depends on having knowledgeable and conscientious trustees.	Regulations are in place and the FCA supervises GPPs to ensure that they do not profit unfairly at the expense of pension members.
Safeguarding of any assets	The trust-based regime, under which action may only take place after an adverse event, may be less effective at avoiding adverse events.	The more pro-active FCA regime may be more effective at avoiding adverse events.

When selecting a pension scheme, employers should bear in mind that:

- The scheme must meet the criteria for automatic enrolment. Typically GPPs and Master Trusts meet these criteria.
- The scheme needs to accept them. While only the National Employment Savings Trust (NEST) is required to accept all employers, some other providers have also committed to doing so.
- At present there is a charge cap for default funds of 0.75% p.a. used by providers for automatic enrolment. However, this charge cap does not apply to transaction costs (costs incurred to buy, sell, borrow or lend investments within the pension fund) or to any fees charged to employers.

Providers offer different propositions to employers. Both Master Trust and GPP providers are required to ensure that they meet the regulatory requirements made of them, and may provide the following:

- Member communications that employers can tailor to their workforce.
- On-line information provision (for example a portal for employers and/or on-line account for employees).
- A helpline for employees.
- Advice around linking with payroll software.
- Management information around the relevant section of the pension scheme.

Differences in the regulatory regimes mean that GPPs may provide more detailed information to pension members than Master Trusts. FCA's communication provision standards make provisions around areas such as sentence length, the ordering of information and the use of white space.

Charge levels and other considerations for employers

For both types of pensions, employers may wish to take into consideration the value for money that the scheme offers their employees.

There is no single definition of 'value for money'. Instead, how it is interpreted is likely to depend on members' objectives. Employ-

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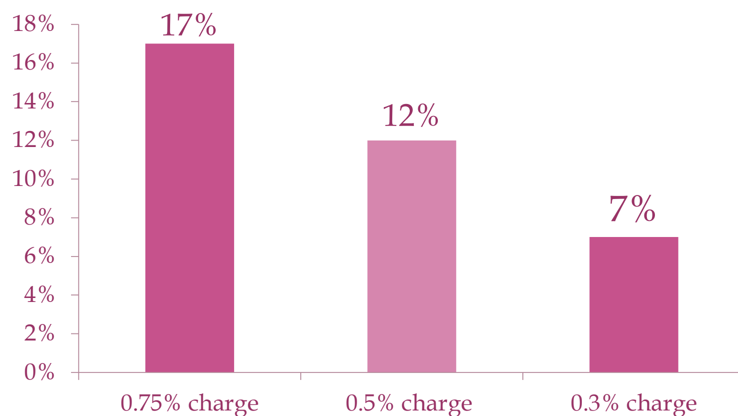
ers will need to consider areas such as governance, member communications, service and administration in the light of their members' objectives, in addition to investment charges.

Chart 5 shows how, all other things being equal, charges can make a difference to members' outcomes. Where a median earning man pays an Annual Management Charge (AMC) of 0.75% he would pay charges equal to 17% of his pension pot. In contrast, where the same man pays an AMC of 0.5% he would pay charges equal to 12% of his pension pot and where he pays an AMC of 0.3% he would pay charges equal 7% of the pot. This shows an adverse impact on member outcomes where there are higher charges.[6]

Chart 5: The charging structure affects the proportion of a DC fund paid in charges

Percentage of a total DC fund paid in charges for men with median earnings under automatic enrolment



However, charges are only one of aspect that an employer should take into account when assessing a pension scheme and 'value for money'. The quality of a pension scheme is likely to have an important impact on member outcomes, for example where effective governance arrangements are in place to ensure that funds are effectively managed and that the pension scheme is managed in line with members' preferences.

Another consideration for employers is whether the scheme offers a 'net pay' arrangement or not. "Net pay" arrangements do not have a mechanism for those earning below £10,600 to claim tax relief they are entitled to on their contributions.

Implications of adverse events for Master Trust members

Concerns around lack of barriers to entry and active supervision centre on the possibility of the winding up of Master Trusts, in particular where they do not achieve the necessary scale for automatic enrolment.

While it is not yet possible to know the exact implications of negative events, such as being wound up, Box 1 provides an overview of some potential outcomes.

Box 1: Considerations for winding up a Master Trust

Pension members

Where investments have been mismanaged or internal controls are not in place, this can lead to lower values of pension assets than if the negative events had not taken place.

Where a Master Trust winds up, trustees would be required to cover the administration costs. As such, these would be taken from the pension scheme funds, reducing the value of their funds.

Employers

Where an employer enrols their employees into a pension scheme that is not managed effectively, they have the burden of moving their employees into a different pension scheme.

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Conclusions

The selection of a pension scheme will, to some degree, depend on an employer's objectives for that scheme.

While the trust-based regime can encourage the provision of pensions with excellent governance structures, TPR relies on trustees and whistle-blowers to take action and this may take place only after the occurrence of an adverse event. In contrast, while the FCA regime is considered relatively rigorous, its approach may not be as appropriate for workplace pensions where the member is typically not able to choose to change pension scheme.

Both trustees and IGCs are now required to assess the value for money of their DC pensions. Employers may wish to assess all attributes of a scheme rather than just the level of charges, to ensure that the scheme that they select meets their, and their members', objectives.

1 The Pensions Regulator (2015) *Automatic enrolment: Commentary and analysis: April 2014-March 2015*
2 http:www.thepensionsregulator.gov.uk/en/employers/duties-checker
3 PPI (2015) *Comparison of the regulatory frameworks for DC pensions*
4 Information available at http://www.thepensionsregulator.gov.uk/press/pn1413.aspx
5 www.fscs.org.uk/what-we-cover/products/pensions/?gclid=CJbmyZa3vcgCFSnkwgodNU8EXg
6 The accumulation paths modelled assume a median male will make contributions from age 22 in 2017 until State Pension Age, currently legislated to be 68.The contribution amount is 8% of band earnings.

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Comparison of the regulatory frameworks for DC pensions

Additional research

The PPI has published a report **Comparison of the regulatory frameworks for DC pensions** which draws on discussions conducted with experts on regulation, and desk research, to explore the differences between the two regulatory regimes for DC pensions. It considers the pros and cons of the respective regimes for DC pensions with a focus on the impact of these for savers. The research was commissioned by Scottish Widows. To download a copy of the report please visit the PPI website.

We are grateful to Scottish Widows for sponsoring this research.

For more information on this topic, please contact
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