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# Comparison of the regulatory frameworks for DC pensions

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# Comparison of the regulatory frameworks for DC pensions

# Executive Summary

The implementation of automatic enrolment and the introduction of new pension flexibilities have meant an increased role for regulators to ensure that new policies work to the benefit of pension savers. At the same time, the challenges for regulators have increased. For example, automatic enrolment means that a greater number and wider range of employers are offering pensions to their employees, and the new pension flexibilities have brought about increased possibilities for pension scams.

In order to address some of these concerns, Scottish Widows commissioned research to explore the advantages and disadvantages of the two main regulatory regimes for pension saving. This research provides an independent assessment of the Financial Conduct Authority (FCA) and the trust-based regime for pensions, implemented by The Pensions Regulator (TPR), in terms of supporting good member outcomes in retirement.

The PPI conducted 13 interviews with representatives from different organisations, including pension providers, legal experts, advisers and employers' organisations, around the effectiveness of the respective regulators. This report draws on discussions with these interviews as well as desk research.

**Particular aspects of workplace pensions mean that there is a need for regulation**

Complexity of pension arrangements, the need for specialist management and the fact that outcomes may not be apparent for some years mean that it is difficult for members to assess whether they are receiving value for money.[1] This results in the need for external regulators to ensure that members are treated fairly and have access to strategies that best suit their needs.

**Broadly, trust-based Defined Contribution (DC) pensions are regulated by TPR and contract-based DC pensions are regulated by the FCA**

- **TPR** regulates workplace trust-based pension schemes. The activities regulated include administration and employers' duties, trust and trustee activity.[2]

- The **FCA** regulates the firms and individuals that promote, arrange or provide contract-based schemes, including Group Personal Pension schemes (GPPs) used in workplaces. Bodies regulated by the FCA in relation to pensions can include financial advisers and investment/asset managers.[3]

Pension trustees are also subject to trust law that applies to areas such as investment powers, while contract-based pensions are subject to contract law that covers areas such as disclosure and fairness. The regulators, in turn, reflect these laws.

[1] Office of Fair Trading (2013)
[2] House of Commons library (2014)
[3] House of Commons library (2014)

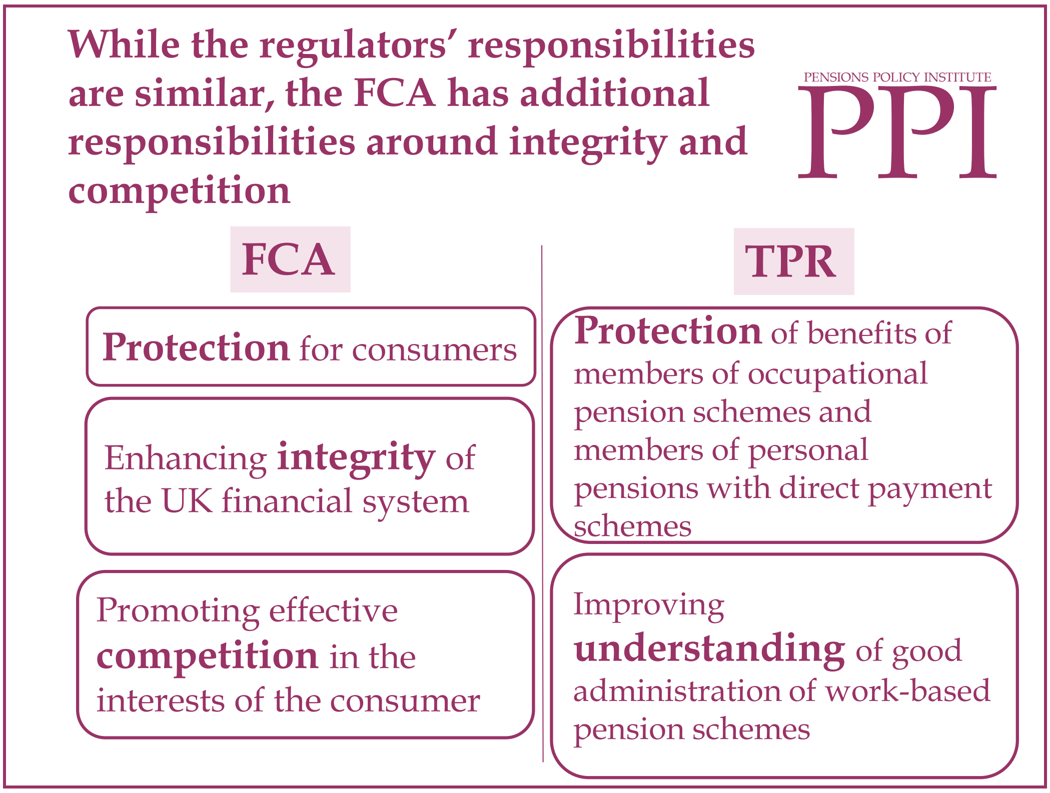
Large financial service organisations, such as insurers, are jointly regulated by the FCA (for conduct) and the Prudential Regulation Authority (for solvency).

While the FCA makes rules for financial services providers and reports to Her Majesty's Treasury (HMT), TPR's role is to regulate according to the rules put in place by the Department for Work and Pensions (DWP). DWP and Her Majesty's Revenue and Customs (HMRC) are responsible for putting in place rules around registration conditions for schemes.

**While the regulators' objectives are similar, the FCA has additional responsibilities around competition and regulation of the market**

The emphases of the two regulators reflects the different models of pension provision of trust and contract-based pensions, with the FCA focusing on the market and having responsibilities that also cover products other than pensions (Chart A).

**Chart A**




The respective approaches of the regulators reflect the different underpinnings of contract and trust-based pensions, as well as the regulators' different expectations of trustees and providers:

- TPR regulates the body of law that relates to trustees who are responsible for overseeing assets on a collective basis, and optimising outcomes at the collective rather than at an individual level.[4]
- The FCA expects providers to optimise each individual's outcomes.

[4] www.thepensionsregulator.gov.uk/press/mark-boyle-professional-pensions-2015.aspx

While both regulators have identified similar types of risk, their approaches are different with TPR focusing on enablement and education. It is also less prescriptive than the FCA in terms of its guidance, particularly around communication to pension savers. In contrast, the FCA is more pro-active in monitoring pension schemes' activities. This difference reflects the fact that it is the trustees who are responsible for playing a supervisory role in the trust-based regime.

**Both regulators have identified risks, particularly, around the pensions freedoms but with only a finite amount of resources, both regulators have to target these at the areas of greatest risk**

Both regulators address the risk that sub-optimal investment decisions and high fees will erode the value of members' DC pension pots. In addition, both have identified risks brought about by the new pension flexibilities, including:

- Individuals using their DC pots at retirement in a way that is not aligned to the individuals' objectives.
- Pension scams, where individuals are encouraged to withdraw their pension savings and place these in a fraudulent product.

In order to address these, both regulators have brought in 'the second line of defence' rules whereby pension schemes have to provide risk warnings to members when they wish to withdraw their pension savings. However, while FCA regulations mean that contract-based pension providers have to give tailored risk warnings, trust-based pensions only have to provide generic warnings. TPR has pointed out that it is the differences between trustees' and providers' responsibilities that account for these (with trustees overseeing a scheme's assets on a collective basis and providers having a direct commercial relationship with each member).[5]

**TPR's role in ensuring that employers make contributions should not be under-estimated, with interviewees rating its communications with employers as good**

As inadequate pension savings constitute the highest risk to adequate retirement income, TPR's role in ensuring that employers make contributions is a large, complex and valuable one. Both employers and advisers rate TPR's communications as good in this area.

**Both regulators have strengths that could helpfully inform approaches taken by the other regulator**

TPR's strengths lie in its pragmatic approach that makes it relatively easy for trustees to comply with the regulations, and the leeway that the legislation allows pension schemes in terms of communication with members.

The FCA's regime is more rigorous and designed to prevent adverse events. This approach may be particularly valuable in terms of emerging priorities, under the Master Trust regime, around the prevention of adverse events.

[5] www.thepensionsregulator.gov.uk/press/mark-boyle-professional-pensions-2015.aspx

Table A summarises the strengths and areas where one regulator may learn from the other in terms of impact on the pension schemes, including members that they regulate. These are then discussed in more detail after the table.

**Table A: Respective strengths of the contract and trust-based regimes**

<table>
<tr><th>Activity</th><th>Contract- based regime (FCA)</th><th>Trust-based regime (TPR)</th></tr>
<tr><td>Rigour of regulatory regime</td><td>Requirement to meet threshold conditions to conduct regulated activities. Ongoing monitoring including:<br>• Supervision<br>• Thematic reviews.</td><td>It relies on trustees and other professionals to report any breaches and to comply with their statutory whistleblowing duties.</td></tr>
<tr><td>Communication with members</td><td>Requirement for communications that reflect where individuals are on the retirement journey.<br><br>Prescriptive around the information provided to members – in some cases, this may make it more difficult for organisations to present information in the most useful way (e.g. if they are required to provide information that will not be used by the member).</td><td>Schemes able to tailor their communications to their members.<br><br>Communications may be designed at the level of the scheme membership and may not reflect an individual's position on their retirement journey.</td></tr>
<tr><td rowspan="2">Compatibility with workplace pensions</td><td colspan="2">Employees do not typically have a choice of pension scheme, this is down to the employer.</td></tr>
<tr><td>FCA's requirement to promote consumer choice of their pension provider is not as relevant under automatic enrolment where it is the employer who chooses the pension scheme.<br><br>This suggests that some of the information (such as the provision of information to help members make choices) provided may not be used and that this may distract</td><td>Schemes have the leeway to provide information relevant to the members' situation – that can reflect the fact that the employer chooses pension schemes under automatic enrolment.</td></tr>
</table>

| Activity | Contract- based regime (FCA) | Trust-based regime (TPR) |
|---|---|---|
| | members from other important information. | |
| Cost (including monetary costs and time) of managing pension schemes | Compliance entails a higher volume of work and cost than required by the trust-based regime.<br><br>Pension providers must receive authorisation for certain activities. | Compliance requires lower volume of work – for example, lower levels of contact with the regulator.<br><br>Trustees have the freedom to make decisions if they judge these to be beneficial to members. |

The trust-based regime is particularly effective in terms of compatibility with workplace pensions and places a lower cost burden on managing schemes. The FCA provides a more rigorous regulatory regime overall in terms of preventing adverse events.

There is an obvious trade-off between rigour on the one hand, and cost and flexibility on the other.

**Authorisation and monitoring by the FCA are more stringent than conditions around a Master Trust. The FCA regime is designed to prevent negative events while the trust-based regime addresses these after the event**

The FCA is a supervisor of entities while TPR oversees trustees; e.g. the FCA will undertake particular activities, such as interviews with staff at all levels and analysis of management information, in order to regulate organisations such as insurers. The FCA regime includes the following requirements:

- Meeting threshold conditions, such as an appropriate level of resources to be authorised to conduct regulated activities.
- Supervision entailing on-going engagement between the firm/individual.

Much of the FCA's approach, such as threshold conditions around adequacy of resources for investment managers, is driven by European legislation.

Under the HMRC and DWP rules, that determine TPR's approach to regulation, the requirements are:

- A Master Trust can be set up with a minimum of only three trustees, provided that the majority are independent of the provider of the scheme.
- Trustees are responsible for the supervisory function, including protection of members' assets.

Trustees have a legal duty to put in place internal controls,[6] and the regulator would expect to receive a 'whistleblowing' report where the implications of inadequate controls are materially significant. Trustees are personally liable and may face action where a breach has occurred. However, there is a concern

[6] TPR *Code of practice no.9*

that, under the trust-based regime, action takes place only once members' assets are at risk.

Interviewees felt that TPR recognises the limitations of its less pro-active regime, particularly in the context of automatic enrolment.

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

The lack of conditions to entry, such as threshold conditions around solvency requirements, in particular, are judged to make it more likely that those Master Trusts without the sufficient scale to profitably operate under automatic enrolment will enter the market – and that these Master Trusts will either wind up or merge.

These concerns do not relate to all Master Trusts, but centre on those Master Trusts not deemed to have the scale for the mass market of automatic enrolment (with some exceptions around smaller Master Trusts designed for the top end of the market) and/or effective governance.

Other concerns linked to the lack of supervision relate to issues around poor management of Master Trusts leading to poorer outcomes for employees.

It is not yet possible to know the exact implications of negative events, such as being wound up, for Master Trusts. However:

*Pension members*

- Where investments have been mismanaged or internal controls are not in place, this can lead to lower values of pension assets.
- Where a Master Trust winds up trustees would be required to cover the administration costs and, as such, these would be taken from the pension scheme funds.

*Employers*

- Where an employer enrols their employees into a pension scheme that is not managed effectively, they may have the burden of moving their employees into a different pension scheme (but has no recourse to move existing funds).

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, including that the firm is unable, or likely to be unable to satisfy claims itself, that the firm owes the claimant a civil liability and that the claimant is a person who is eligible to claim compensation. Trustees of occupational pension schemes, including schemes set up under Master Trusts, may be eligible to claim compensation, subject to the conditions in the rules being met. More information is available on the FSCS website.[7]

[7] www.fscs.org.uk/what-we-cover/products/pensions/?gclid=CJbmyZa3vcgCFSnkwgodNU8EXg

**New regulations and the introduction of the Master Trust Assurance Framework (although not mandatory) represent a move towards a more stringent approach for trust-based pensions**

The Master Trust Assurance Framework (MTAF), introduced in April 2015, was developed to help trustees to assure the quality of their scheme and to address some of the concerns around the quality of pension schemes. However, it is not currently mandatory for Master Trusts to complete this although it has been reported that TPR is considering making it mandatory.[8]

As part of the MTAF a charge cap and governance regulations were introduced for trust-based pensions, although the charge cap applies only to the default funds in both GPPs and trust-based pensions used for automatic enrolment. This cap limits charges to 0.75% for default funds and brings in new requirements for trustees such as reviewing operational processes and considering whether charges represent good value for money.[9,10]

**There is a concern that a lack of transparency may lead to worse outcomes for some pension savers, under both regimes, and that TPR, in particular, has no remit to protect the integrity of the market**

Interviewees noted a move towards services, including advice, administration and fund management, being bundled via a Master Trust. While this may result in efficient provision of services in some cases, there were concerns that this might lead to conflicts of interest, for example, where advisers promote more than one product or service. A 'bundle' also makes it more difficult for employers to assess the value provided by the Master Trust's product, potentially adversely affecting value for money for the individual.

There is a concern that some boards of trustees will not feel able to appoint investment managers other than those linked to the adviser or provider that has sponsored the Master Trust. While a recent change in regulations by DWP was introduced to ensure that trustees are not locked in by providers or advisers to in-house administration or investment services, some trustees may not choose to exercise this choice.

The issue of bundling has also been noted for contract-based schemes. The assessment of value for money is one of the responsibilities of Independent Governance Committees (IGCs) that have recently been introduced.

Another issue for the trust-based regime, raised during interviews, is around unregulated advisers setting up some Master Trusts, something that may have an adverse impact on the market in terms of transparency and competition. This was seen as something that might not be effectively addressed under the trust-based regime, as TPR does not have a remit to promote competition and protect the integrity of the market.

[8] www.engagedinvestor.co.uk/Story.aspx?storyCode=14746697&utm_source=Adestra&utm_medium=email
[9] DWP (2015)
[10] This does not include 'transaction charges' – charges related to the buying and selling of assets in a pension scheme

It should be emphasised that these are potential risks and it remains to be seen whether members are affected adversely by these arrangements. Moreover, there are some Master Trusts with extremely effective governance arrangements. In particular, these issues may be more likely to arise where profit is an over-riding objective for the organisations that sponsor the Master Trust.

Despite this, the recent introduction of the charge cap and new governance standards indicates recognition by the DWP of the need for protection of members' interests in the context of the pensions market.

**The extent to which one of the regulatory regimes is more likely to be effective depends on providers' motivations in making available a pension scheme**

Where the primary motivation is around providing a benefit to workers, such as in a single employer trust-based pension scheme or large not-for-profit scheme, the trust-based regime may well be effective. According to this type of model, trustees are responsible for supervising administrators and investors for the benefit of members and are motivated to do so. Moreover, the trust-based regime allows trustees the leeway to adapt their approach to the needs of employees. However, where there may be conflicting commercial objectives, such as profit-making, the FCA regime may be more effective, in terms of working towards better outcomes for the pension member, by ensuring that organisations do not pursue other objectives at the expense of scheme members.

**The FCA's prescriptive approach to member communications may not be as appropriate for workplace pensions, where the member is typically not able to choose to change pension scheme**

There is some leeway around how trust-based pensions communicate with members. In contrast, the FCA is prescriptive around the information that pension schemes have to provide to members, reflecting its commitment to treating customers fairly and in promoting competition. The FCA's requirement to promote consumer choice may not be as relevant for workplace pensions, including automatic enrolment, where it is the employer who chooses the pension scheme and therefore the provider.

This suggests that some of the information (such as the provision of material to help members make choices) may be unnecessary and may distract the reader from key communications on other points.

**While competing views exist around whether there should be a single regulator, there was a consensus among research interviewees that combining the regulators would not be straightforward**

The issue of regulatory arbitrage – where a pension scheme is set up in a particular way so that it is regulated under one of the regimes rather than the other – was touched upon in interviews. However, it is not clear that having a single regulator would address this to a greater degree than bringing in line some of the main causes of regulatory arbitrage such as the threshold conditions for starting a pension scheme. A further barrier would be the volume of contract, tax, trust and pension law needing to be changed to accommodate a move to a single regulator.

The interviews generated some objections to or questions around having a single regulator:

- It was felt that the burden on employers should not be increased at a time when they are experiencing a high regulatory burden, due to the implementation of automatic enrolment.
- It was not clear where a single regulator should sit – whether this would be in the Department for Work and Pensions (DWP) or Her Majesty's Treasury (HMT).

**There are concerns around individuals, organisations and products that are not regulated, and it was felt that any failure in pensions regulation would be felt by the whole of the pensions industry**

Both desk research and interviews with experts drew attention to risks brought about by those individuals, organisations and products that either fall outside the regulatory regimes or have not applied for authorisation when they should be regulated. An area that has received concern in the press is the role of international advisers, not regulated in the UK, and their potential role in recommending unsuitable investments.[11]

If one of the regulatory regimes were not successful in preventing member detriment, it was felt that the reputation of the pensions industry as a whole would suffer and, for this reason, the effectiveness of both the regulators is important across the board.

**Conclusions**

Particular aspects of workplace pensions mean that there is a need for regulation.

TPR's role in ensuring that employers make contributions should not be underestimated, with interviewees rating its communications with employers as good and appreciating its pragmatic approach.

Both regulators have strengths that could helpfully inform approaches taken by the other regulator.

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

New regulations and the introduction of the Master Trust Assurance Framework (although not mandatory) represent a move towards a more stringent approach for trust-based pensions.

There is a concern that a lack of transparency may lead to worse outcomes for some pension savers, under both regimes, and that TPR, in particular, has no remit to protect the integrity of the market.

While competing views exist around whether there should be a single regulator, there was a consensus that combining the regulators would not be straightforward.

[11] www.ftadviser.com/2015/06/05/investments/unregulated-advisers-under-fire-YyFN0ZnWNuXYjK7K7l8qiK/article.html

# Introduction

The UK pension system continues to be in flux. The implementation of automatic enrolment and the introduction of new pension flexibilities have meant an increased role for regulators to ensure that new policies work to the benefit of pension savers. At the same time, the challenges for regulators have increased; automatic enrolment means that a greater number and wider range of employers are offering pensions to their employees, and the new pension flexibilities have brought about increased possibilities for pension scams.

Both the Financial Conduct Authority (FCA) and The Pensions Regulator (TPR) have an important role in facilitating the availability of pension schemes that are suitable for these employers and their employees under automatic enrolment. Similarly, regulation is central to the protection of pension savers from pension scams.

Employers have typically selected a Defined Contribution (DC) pension arrangement and typically chosen either a Master Trust or Group Personal Pension (GPP) to meet their duties under automatic enrolment. Each of these arrangements has different regulatory regimes with Master Trusts being regulated by TPR and GPPs being regulated by the FCA. This has brought into focus the question of whether these pension arrangements and their respective regulatory regimes are likely to bring about different outcomes for members and their employers.

In order to address some of these concerns, Scottish Widows has commissioned research that explores the advantages and disadvantages of each of the regulatory regimes. This research should provide an independent assessment of these in terms of supporting good member outcomes in retirement.

The PPI conducted 13 interviews with representatives from different organisations, including pension providers, legal experts, advisers and employers' organisations, around the effectiveness of the respective regulators.

This report draws on discussions with those interviewed as well as desk research. However, in order to ensure that the research remains independent and to highlight where findings are based on opinion, any observations made during these interviews are reported separately to any conclusions reached via desk research.

The first chapter of this report describes arrangements of trust and contract-based pension schemes. It goes on to provide an overview of the regulatory regimes for DC pensions, including the history and objectives.

The second chapter considers how the FCA and TPR assess and regulate risk in DC pension arrangements. It also considers rules, under each regime, around communications with members.

The third chapter explores the advantages and disadvantages of each regulator and considers arguments for a single regulator for DC pensions.

The fourth chapter provides an overview of considerations for employers.

# Chapter one: current regulatory regimes

This chapter provides a brief overview of the different types of Defined Contribution (DC) pension arrangements that exist within the UK, along with recent developments that have implications for the regulatory regimes.

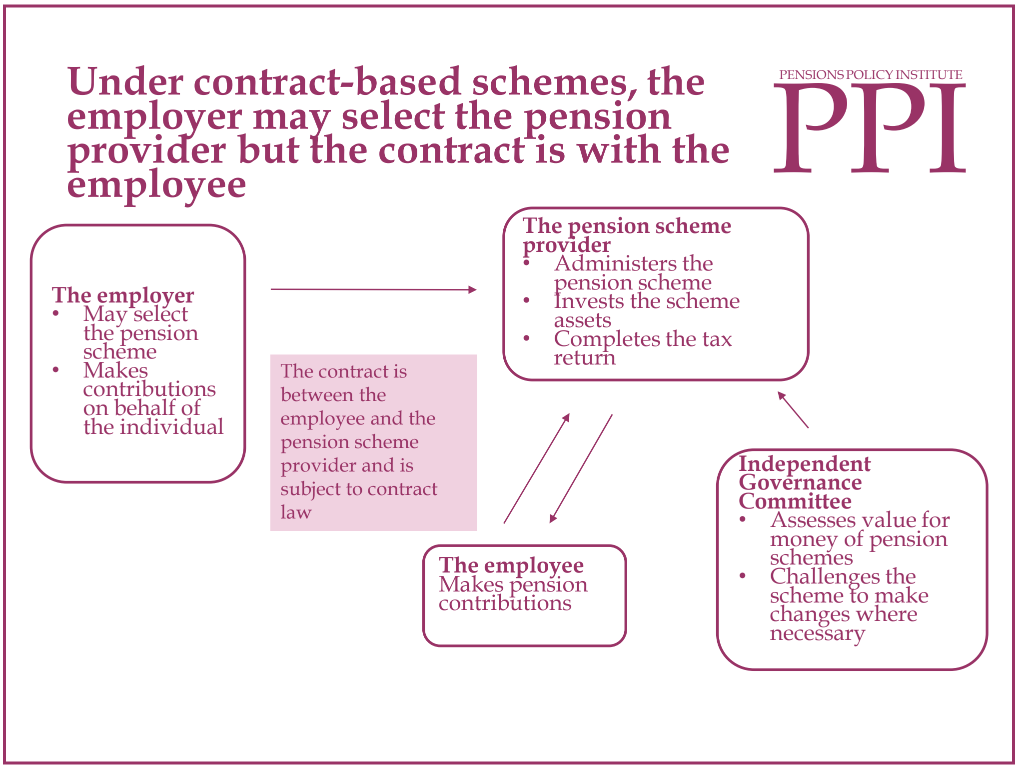
It goes on to outline the need for regulation of DC pensions and to provide an overview of the coverage of the Financial Conduct Authority (FCA) and The Pensions Regulator (TPR) with reference to the roles of the Prudential Regulation Authority (PRA) and Her Majesty's Revenue and Customs (HMRC). Finally, it outlines the objectives for each regulator.

**Contract and trust-based pension schemes are the principal types of DC pension arrangements in the UK**

The two types of pension arrangement considered in this report are contract and trust-based DC pensions. These arrangements are informed by very different underpinnings which, in turn, have informed the types of regimes that regulate them.

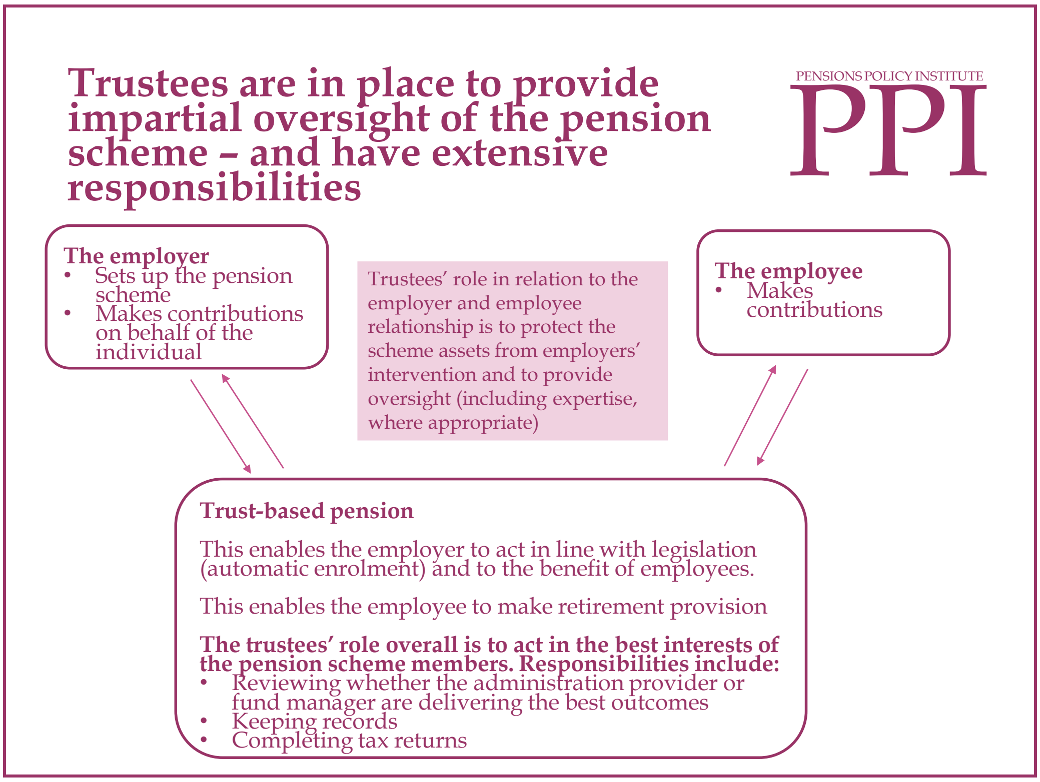
Under contract-based arrangements (Chart 1), the contract is between the employee and the pension provider, usually an insurer, and is subject to contract law, which covers areas such as unfair conditions. These pensions may be purchased by an individual or organised by their employer. Independent Governance Committees (IGCs) have recently been introduced as an additional layer of protection for members of workplace contract-based pension schemes. These assess the value for money of pension schemes.

**Chart 1**



Under trust-based arrangements (Chart 2), the scheme's assets are held by trustees who are required to act impartially in the interests of the scheme members and protect these assets from the employer's intervention.

**Chart 2**




Master Trusts (trust-based pension schemes established to provide benefits to multiple employers) do not fit easily into either model as, under these arrangements, the employer selects the Master Trust rather than sets up the pension scheme. At the same time, unlike the contract- based model, there is not an individual contract between the pension member and the pension provider.

### Particular aspects of workplace pensions mean that there is a need for regulation

The roles of both regulators reflect the fact that it is difficult for members to assess whether they are receiving value for money.[12] This results in the need for an external body to ensure that they are treated fairly and have access to strategies that best suit their needs for the following reasons:

- Private pension provision is complex, in terms of both the products themselves and the market.
- Private pension provision demands specialist management, and needs to be efficient over a long period of time.[13]
- Outcomes may not be apparent for some years.[14]

An issue specific to workplace pensions is the fact that it is typically the employer who selects the pension scheme on behalf of the employee – this brings

[12] Office of Fair Trading (2013)
[13] DWP (2014)
[14] Office of Fair Trading (2013)

with it particular risks (employers lacking capability or incentives to ensure that employees receive value for money in the long-term)[15] and the need to balance interests, which are not necessarily aligned.[16]

**The implementation of automatic enrolment emphasises the need for regulation**

The implementation of automatic enrolment, under which employers are required to select and contribute to a pension scheme on behalf of their employees, has implications for the regulation of pensions. While those employers who provided pension schemes in the past did this by choice, many of those employers who have been required to provide a pension as a result of automatic enrolment may be less likely to be committed to and knowledgeable about pensions. This, in turn, suggests that the regulators may need to play a greater role than in the past to ensure that these employers are able to select good quality pension schemes for their employees.

Automatic enrolment has led to a greater use of Masters Trusts. To date, 51% of pension schemes used for automatic enrolment have been Master Trusts and 46% have been contract-based Group Personal Pensions (GPPs).[17,18]

Concerns have been voiced around the increased role of corporate advisers, under automatic enrolment, who are not required to be regulated. Specifically there is the concern that advice may be overly influenced by the profit motive in the absence of regulation that works to ensure that employers are treated fairly.

It should be emphasised that these are potential risks, and that many advisers are able to combine the motivation to make a profit and to provide services that are in the best interests of their clients.

**Broadly, trust-based DC pensions are regulated by TPR and contract-based DC pensions are regulated by the FCA**

Box 1 shows the types of pension arrangements regulated by the FCA and TPR respectively, along with other bodies relevant to regulation.

Pension trustees are also subject to trust law that applies to areas such as investment powers while contract-based pensions are covered by contract law that covers areas such as disclosure and fairness. In turn, the regulators reflect these laws.

Large financial service organisations, such as insurers, are jointly regulated by the FCA (for conduct) and the PRA (for solvency). While the regulators do not duplicate work, different regulators can regulate specific elements of one pension scheme.

[15] Office of Fair Trading (2013)
[16] DWP (2014)
[17] GPPs are arrangements in which the pension scheme is selected by the employer but the contract is with the employer
[18] TPR (2015)

While the FCA makes rules for financial services providers and reports to Her Majesty's Treasury (HMT), TPR's role is to regulate according to the rules put in place by the Department for Work and Pensions (DWP). DWP and Her Majesty's Revenue and Customs (HMRC) are responsible for putting in place rules around entry conditions for schemes.

**Box 1: Principal regulatory bodies[19,20]**

**The Pensions Regulator (TPR)** regulates workplace trust-based pension schemes. The activities regulated include administration and employers' duties, trust and trustee activity. TPR also regulates the administration of work-based personal pension schemes.

The **Financial Conduct Authority (FCA)** regulates the firms and individuals that promote, arrange or provide contract-based schemes, including Group Personal Pensions (GPPs) used in workplaces. Bodies regulated by the FCA in relation to pensions can include financial advisers and investment/asset managers.

The **Prudential Regulation Authority (PRA)** regulates the capital adequacy (checking that they have sufficient resources to continue trading and to pay their liabilities) for large financial services organisations.

**Her Majesty's Revenue and Customs (HMRC)** authorises pension providers to give tax relief on pension payments at source.

**Other bodies that support pension savers**

Employees can contact the **Financial Ombudsman Service (FOS)** where they have a complaint that has not been resolved by their financial services provider. The FOS can order providers to pay compensation to an individual.

The **Pensions Ombudsman** also deals with matters around pensions where complaints have not been resolved. A memorandum of understanding between The Pensions Ombudsman and the Financial Ombudsman Service clarifies their division of work:

- The Pensions Ombudsman deals with matters around the administration and management of personal (after sale or marketing) and occupational pensions.
- The Financial Ombudsman deals with matters concerning advice around the sale or marketing of individual pension arrangements.

The **Financial Services Compensation Scheme** (FSCS) is the compensation scheme of last resort for customers of financial services firms that are authorised by the FCA and the PRA and that are unable, or likely to be unable, to satisfy claims against them.

Occupational pension schemes can obtain compensation from the **Fraud Compensation Fund** in the case of an insolvent employer where they suffer a loss caused by an offence involving dishonesty.

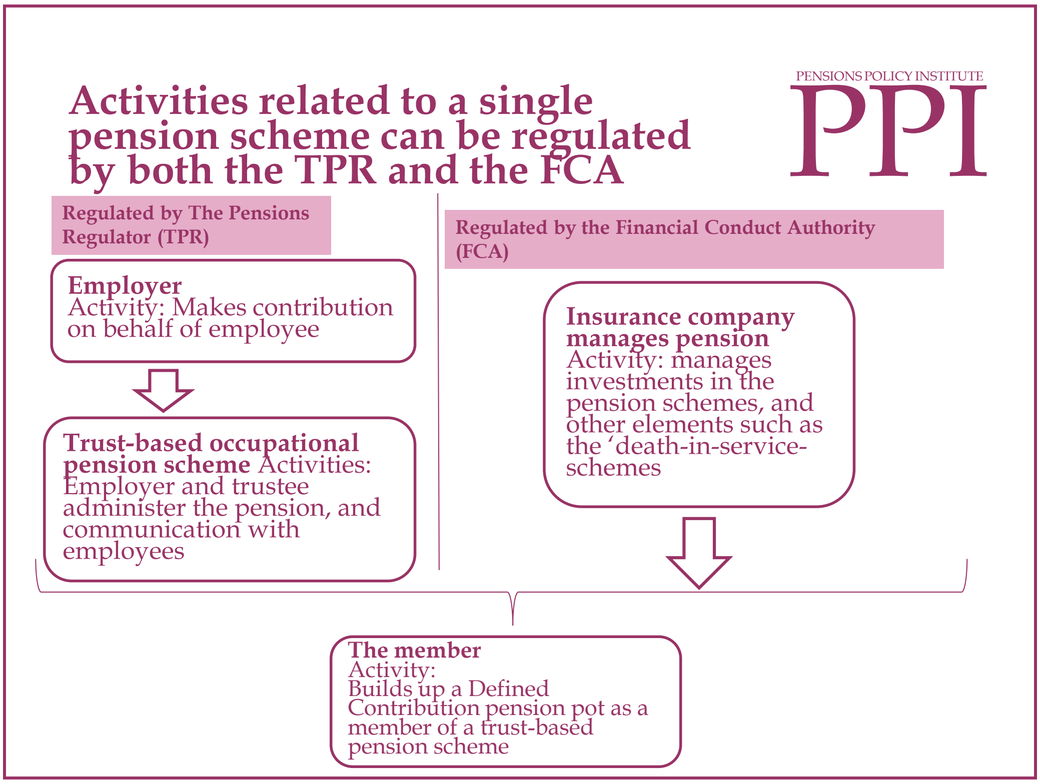
[19] House of Commons library (2014)
[20] www.financial-ombudsman.org.uk/publications/pdf/memorandum-of-understanding.pdf

The development and behaviour of both regulators reflects their respective histories:

- TPR was set up to replace the Occupational Pensions Regulatory Authority (OPRA). It aims to be risk-based and pro-active.
- The bulk of trust-based, and therefore TPR's work, has historically been around Defined Benefit (DB) pensions. Therefore, TPR has, in the past, worked with mainly larger employers who have chosen to provide relatively generous pensions. Under these arrangements, trustees play the supervisory role in the pension provision. This may account, in part, for the emphasis on education and enablement that originates in an assumption that employers wish to provide good quality pensions to their employees.
- The FCA was part of the new regime set up as part of the Financial Services Act 2012 to protect the UK economy following the financial crisis, and replaced the Financial Services Authority (FSA). It regulates other financial services providers as well as pensions and has dealt with issues such as the mis-selling of Payment Protection Insurance. Therefore, its attitude towards financial services providers is at times perceived as one of mistrust.
- The FCA has rule-making abilities and is therefore able to draft regulations with which financial services providers are required to comply. In contrast, TPR has codes of practice – these are not mandatory but are intended to help employers and trustees to comply with the regulations that originate from the Department for Work and Pensions (DWP).

In practice, different activities related to a single pension scheme can be regulated by both TPR and the FCA. For example, in a trust-based pension scheme, trustees' and employers' activities are regulated by TPR. However, if an insurance company manages the investments in a trust-based scheme, then these activities are regulated by the FCA (Chart 3). TPR is charged with making sure that employers make their contributions even where the employer has chosen to use a GPP. In practice, the saver is unlikely to be aware of how their pension savings are regulated.

**Chart 3**




In addition, the regulators work together to co-ordinate their approach, to minimise any duplication and to work towards a consistent approach to the regulation of work-placed pensions.[21]

**While the regulators' responsibilities are similar, the FCA has additional responsibilities around competition and integrity of the market**

The emphases of the two regulators reflect the different models of pension provision of trust and contract-based pensions, with the FCA focusing on the market and having objectives that also cover products other than pensions (Chart 4).

Both regulators' ultimate aim is to protect pension savers. The regulatory models reflect the mechanisms through which each model of pension provision looks to achieve this. Under trust-based pensions this is through the appointment by employers of impartial trustees whose role is to protect pension savers' assets, manage conflicts of interest between the employer and pension member, and have oversight of the management of the pension funds. Therefore, the emphasis of the regulator is on the education and enablement of trustees to perform their role effectively.

In contrast, under contract-based pension schemes, pension providers are responsible for the oversight of pension assets and there may be some conflicts of interest between the provider's and the member's interests. The higher level of scrutiny by the FCA, including scrutiny of the markets, reflects this.

[21] FCA and DWP (2014)

**Chart 4**

**While the regulators’ responsibilities are similar, the FCA has additional responsibilities around integrity and competition**

| FCA | TPR |
|---|---|
| **Protection** for consumers | **Protection** of benefits of members of occupational pension schemes and members of personal pensions with direct payment schemes |
| Enhancing **integrity** of the UK financial system | Improving **understanding** of good administration of work-based pension schemes |
| Promoting effective **competition** in the interests of the consumer | |

On paper at least, each regulator has similar types of powers in some respect (Chart 5) although these differ in terms of the subject of regulation – for example, the FCA has the power to remove a product from the market if it suspects consumer detriment.

**Chart 5**[22,23]

**Both regulators have powers to intervene where DC pensions have not been managed in line with the regulations**

| FCA | TPR |
|---|---|
| Impose fines | Impose fines where it detects a breach or is notified by statutory whistleblowers |
| Suspend or prohibit firms | Suspend or prohibit trustees |
| Prosecute certain offences in the criminal courts | Prosecute certain offences in the criminal courts |
| Order injunctions | Issue notices |
| Remove product from the market if it suspects consumer detriment | Recover unpaid contributions from employers |

[22] www.fca.org.uk/firms/markets/our-powers
[23] www.thepensionsregulator.gov.uk/regulate-and-enforce/our-powers.aspx

# Chapter two: Regulators' approach to recent developments

This chapter provides an overview of the regulatory approach of The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) respectively, including how organisations are authorised and supervised under each regime. It provides an overview of each regulator's approach – the advantages and disadvantages of these are considered later in chapter three of this report.

This chapter lists the different types of risks to pension savers identified by each regulator and by those individuals interviewed by the PPI about regulation in the current pensions context. It goes on to consider the regulators' responses to these risks.

Each regulator's approach to regulation reflects its stance:

- Trust-based pension schemes look to optimise outcomes at the level of the group of members.
- Contract-based pension schemes are designed to optimise outcomes at the individual member level.

**Authorisation by the FCA to conduct regulated activities is more stringent than those conditions required to set up a Master Trust**

The FCA requires organisations and individuals to meet threshold conditions in order to be authorised to conduct regulated activities. These include having levels of resources and a business model appropriate for the activity that the organisation is looking to conduct. Much of the FCA's approach, such as threshold around adequacy of resources for investment managers, is driven by European legislation. In contrast, under Department for Work and Pensions (DWP) and Her Majesty's Customs and Excise (HMRC) rules, a Master Trust can be set up with only three trustees, provided that the majority are independent of the provider used by the scheme.

The TPR has a code of practice that requires that all trustees should be 'fit and proper' (e.g. have not committed certain offences) and that trustees for whom specialist knowledge is required should be appropriately qualified.[24] However, the approach differs from that taken by the FCA – the FCA has to authorise pension providers **before** they can conduct business. In contrast, a person may act as a trustee without similarly stringent entry controls. TPR may take action to replace or prohibit trustees found acting contrary to the law.

**A pro-active approach to identifying problems is built in to the FCA's assessment of risk**

The FCA looks to identify issues through the supervision of firms that it regulates and also tests to find out whether these issues are widespread throughout a particular sector.

It describes its three-pronged approach as:

- Pro-active firm supervision

[24] www.thepensionsregulator.gov.uk/codes/code-governance-administration-occupational-dc-trust-based-schemes.aspx

- A reactive approach to issues that arise[25]
- Whole sector issue and product supervision, which investigates possible drivers of poor outcomes for consumers and the market.[26]

**While TPR also identifies possible challenges and risks, its primary approach remains the enablement and education of employers and trustees**

TPR also outlines a risk-based approach and takes action (such as the appointment of an independent trustee to a pension scheme) where it finds that a scheme is in breach of the law which poses a significant risk of not delivering adequate outcomes for members. It has also tried to assess the extent of risks in specific areas, such as its thematic review of record keeping.

There is no public programme of thematic reviews, and its primary focus remains the enablement and education of employers and trustees. TPR assesses risk in a number of different ways including by targeted research and use of shared intelligence.

While this section can provide a comparison of each regulator's approaches to risk, it is only by assessing outcomes that we will know whether their approach is proportionate to the level of risk present in each type of arrangement. It will not be possible to know all of the outcomes of automatic enrolment for some time. However chapter three looks to provide some assessment of whether each regulator's approach is proportionate.

**Both regulators require pension providers and trustees respectively to submit information on an on-going basis to enable assessment of risks to pension savers**

- **FCA Supervision**

The FCA expects firms to adhere to its FCA Principles for Businesses that cover areas such as integrity. The approach to supervision will depend on how risky the firm's activities are assessed to be. Tools used by the FCA include meetings, reviews of management information and deep dive assessments (that might include desk-based analysis, on-site testing, walk-through discussions and call listening).

- **TPR's principles and Chair's statement**

TPR published a code of practice in 2013 which was structured around six principles that should inform trustee's conduct. The principles cover areas such as durability of the scheme, features to deliver good outcomes (such as a suitable default fund), transparent costs and protection of assets. These also focus on the effectiveness of schemes' governance frameworks and administration.

Codes of practice are not statements of the law and there is no penalty for failing to comply with them. They are not equivalent to the FCA's rule making power. However, a court or tribunal must take the provisions of a code of practice into account when determining whether trustees have complied with their legal duties.

[25] an example is the introduction of regulations around pension schemes' communications with members following the introduction of the new pension flexibilities
[26] An example is the thematic review of annuities

From April 2015, it is mandatory for trust-based pension schemes to submit a Chair's (of trustees') statement that explains how the scheme has fulfilled new governance standards described in the next section. The governance standards are based on the key areas of risk identified by TPR in its 2013 code of practice and accompanying guidance. The code is being reviewed, and TPR will set out its revised expectations, TPR is formally consulting on this document in November 2015.

**New regulations represent a move towards a more stringent approach for trust-based pensions**

A charge cap and new governance regulations were introduced from April 2015 for trust-based pensions, although the charge cap applies to both GPPs and trust-based pensions used for automatic enrolment. This limits charges to 0.75% for default funds used for automatic enrolment.[27]

The new governance standards require trustees to cover the following:

- knowledge about the scheme
- administration processes
- good value for money
- governance requirements for the schemes' default arrangements

In addition, TPR has worked with the Institute of Chartered Accountants in England and Wales (ICAEW) to publish a voluntary assurance framework for Master Trusts. Providers can apply to assess this framework to demonstrate compliance with TPR's quality standards. At the time of writing, 4 out of approximately 70 Master Trusts[28] have completed the assurance framework. However, a significant number of the total number of Master Trust members belong to these 4 Master Trusts.

**Both regulators have identified risks, particularly, around the pensions freedoms but, with only a finite amount of resources, they have to target these at the areas of greatest risk[29,30]**

Both regulators address the risk that sub-optimal investment decisions and high fees will erode the value of members' DC pension pots. In addition, both regulators have identified risks brought about by the new pension flexibilities, including:

- individuals using their DC pots at retirement in a way that is not aligned to their objectives.
- pensions scams where individuals are encouraged to withdraw their pension savings and place these in a fraudulent product.

In order to address both of these risks both regulators have brought in 'the second line of defence' rules whereby pension schemes have to provide risk warnings to members when they wish to withdraw their pension savings. However, while FCA regulations mean that contract-based pension providers

[27] This does not include 'transaction charges' – charges related to the buying and selling of assets in a pension scheme

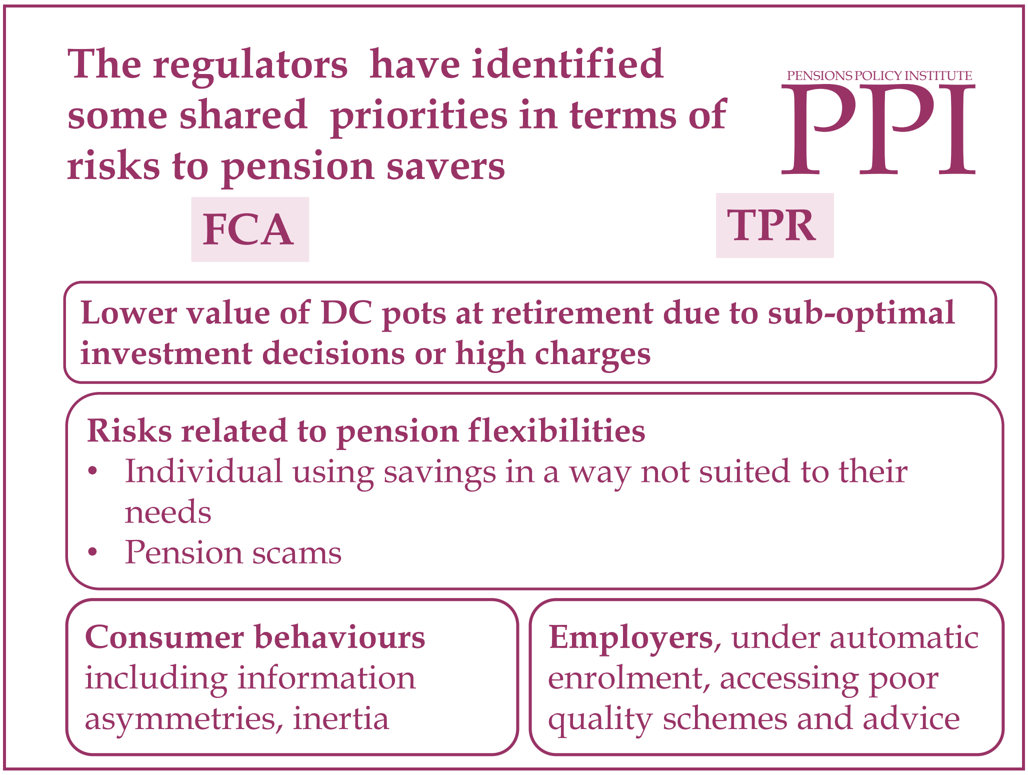
[28] www.professionalpensions.com/professional-pensions/news/2352950/pension-master-trusts-the-definitive-list-of-providers

[29] TPR (2015)

[30] FCA (2015)

have to give tailored risk warnings, DWP rules (used by TPR) require trust-based pensions to provide generic warnings only. The rationale for this difference is the differences between trustees' and providers' responsibilities. Trustees oversee a scheme's assets on a collective basis while providers have a direct commercial relationship with each member.[31] Chart 6 shows the risks identified by each regulator.

**Chart 6**




There is a recognition that pension scams exist and in light of the new pension freedoms appear to have migrated towards promises of 'high investment returns', provoking a reaction from both regulators.[32] Both regulators have focused on the provision of on-line resources aimed at educating pension savers about the risks of pension scams.

TPR's resources to deal with such scams are limited. Their plan indicates that they will identify and intervene in a small number of instances where their intervention will cause maximum disruption to key individuals or organisations behind the scams.[33]

As a result of its much wider remit, the FCA has identified risks that cut across the financial services sector, some of which affect pensions, including consumer behaviours, information asymmetries, consumer inertia and vulnerability. It looks to prevent the negative outcomes that might arise from these risks, such as consumer detriment, with its supervisory processes.

[31] www.thepensionsregulator.gov.uk/press/mark-boyle-professional-pensions-2015.aspx
[32] TPR (2015)
[33] TPR (2015)

The types of risk that TPR is looking to address around automatic enrolment centres partly on the role played by employers in choosing the pension scheme. TPR identifies the challenge of enabling small and micro employers to use good quality schemes and access good quality advice and simple guidance, as an area that brings with it additional risks.

Interviewees in this research identified a specific risk for trust-based pensions around trustees not sufficiently being engaged or knowledgeable. The new governance standards for trust-based pensions look to address these issues.

**The FCA is more prescriptive than the trust-based regime around communication with pension savers**

As with the provisions around 'the second line of defence' each regulator's approach can be seen as reflecting different arrangements, whereby trustees supervise the management of assets on a collective basis and providers have a direct commercial relationship with each member.

Therefore, the FCA's communication provision standards are detailed and make provisions around areas such as sentence length, the ordering of information and the use of white space.

Legislation does not give TPR a role in determining the format of member communications. In contrast, TPR's guidance is more general, making recommendations that schemes should ensure that communications are clear, ensuring that members are aware of the current investment strategy and its implications for them, and that costs and charges are clearly disclosed to members.[34]

[34] www.thepensionsregulator.gov.uk/trustees/communicating-with-members-in-your-dc-scheme.aspx

# Chapter three: advantages and disadvantages of the regulators and the implications for members

This chapter outlines the advantages and disadvantages of the regulators, and explores the implications of these for pension members. It focuses on these implications rather than drawing conclusions about their effectiveness, which is difficult to assess:

- even where a regulator is seen to be taking high levels of action, e.g. issuing fines or compliance notices, this may not be effective where the regulator's actions only address a small proportion of non-compliant activities;
- to some extent, the effectiveness of a regulator is demonstrated through the type and scale of activities that it deters individuals and organisations from conducting where these activities would not be in the interest of the pension saver. It may not be clear to onlookers where either regulator has deterred individuals, firms or employers from particular actions.

The exploration of each regulators' strengths and weaknesses will look to take account of the following:

- differences in the context in which each regulator functions;
- the fact that while the primary function of each regulator is to protect pension scheme members, the regulatory requirements should not be so onerous that they deter a significant number of suitable individuals or organisations from performing a function, such as acting as a trustee;
- any assessment takes into account the fact that some areas of pension provision and the regulator's approaches may be risky in theory only; in contrast, this report is interested in the extent to which any risks are likely to end in member detriment.

The remainder of this chapter reflects the findings from 13 interviews with individuals who have expert knowledge of one or both of the regulators supported by extensive desk research. In particular, reference is made to the extent to which each regulator meets its own objectives.

**The findings in boxes and italicised are from the interviews. In some cases the findings are followed by a brief discussion of the key points, reflecting the fact that they arise from a particular set of interviewees' experiences. While these experiences account for interesting and valuable insights into the regulators, they may not be completely objective.**

**TPR's role in ensuring that employers make contributions should not be under-estimated, with interviewees rating its communications with employers as good**

As inadequate pension savings constitute the highest risk to adequate retirement income, TPR's role in ensuring that employers make contributions is a large and complex one. While it is difficult to assess the extent to which TPR ensures that all employers comply with this, from April 2014 to March 2015 around 35,000 employers completed their declaration of compliance and TPR only issued 22 unpaid contribution notices.[35] Research interviewees rate its communications as good in this area and, in particular, appreciated recent improvements to these (Box 2).

**Box 2: Interviewees' views of TPR's communications**

- *Interviewees felt that TPR had made its communications easier to understand and had focused on communicating with the appropriate individual or group, such as accountants and payroll providers.*

- *Interviewees also suggested that it would be helpful to employers and other stakeholders if TPR could take the same approach when drafting the upcoming code of practice that will reflect changes to governance rules and the charge cap.*

**Both regulators have strengths that could helpfully inform approaches taken by the other regulator**

TPR's strengths lie in its pragmatic approach that makes it relatively easy for trustees to comply with the regulations and the leeway that it allows pension schemes in terms of communication with members.

The FCA regime is more rigorous, and designed to prevent adverse events. This approach may be particularly valuable in terms of emerging priorities, under the Master Trust regime, around the promotion of competition and protection of members' asset in the event of the wind-up of a Master Trust (as explored later in this chapter).

Table 1 summarises the strengths and areas where one regulator may learn from the approach adopted by the other for each of the regulators, in terms of impact on the pension schemes, including members that they regulate. These are then discussed in more detail in the following section.

[35] TPR (2015)

**Table 1: Respective strengths of the contract and trust-based regimes**

| **Activity** | **Contract- based regime (FCA)** | **Trust-based regime (TPR)** |
|---|---|---|
| Rigour of regulatory regime | Requirement to meet threshold conditions to conduct regulated activities. Ongoing monitoring including:<br>• Supervision<br>• Thematic reviews | It relies on trustees and other professionals to report any breaches and to comply with their statutory whistleblowing duties. |
| Communication with members | Requirement for communications that reflect where individuals are on the retirement journey.<br><br>Prescriptive around the information provided to members – in some cases, this may make it more difficult for organisations to present information in the most useful way (e.g. if they are required to provide information that will not be used by the member). | Schemes able to tailor their communications to their members.<br><br>Communications may be designed at the level of the scheme membership and may not reflect an individual's position on their retirement journey. |
| Compatibility with workplace pensions | Employees do not typically have a choice of pension scheme, this is down to the employer | |
| | FCA's requirement to promote consumer choice of their pension provider is not as relevant under automatic enrolment where it is the employer who chooses the pension scheme.<br><br>This suggests that some of the information (such as the provision of information to help members make choices) provided may not be used and that this may distract members from other important information. | Schemes have the leeway to provide information relevant to the members' situation – that can reflect the fact that the employer chooses pension schemes under automatic enrolment. |
| Cost (including monetary costs | Compliance entails a higher volume of work | Compliance requires lower volume of work – for |

| Activity | Contract- based regime (FCA) | Trust-based regime (TPR) |
|---|---|---|
| and time) of managing pension schemes | and cost that than required by the trust-based regime.<br><br>Pension providers must receive authorisation for certain activities. | example, lower levels of contact with the regulator.<br><br>Trustees have the freedom to make decisions if they judge these to be to be beneficial to members. |

While the trust-based regime is particularly effective in terms of compatibility with workplace pension and lower cost burden of managing schemes, the FCA provides a more rigorous regulatory regime overall in terms of preventing adverse events. There is an obvious trade-off between rigour on the one hand, and cost and flexibility on the other.

**TPR is broadly characterised as being pragmatic and proportionate, but some interviewees questioned its effectiveness in ensuring good member outcomes**

Regulation by TPR was for the most part seen as proportionate and reflecting the arrangement that trustees are tasked with optimising outcomes for pension scheme members as a group. However, some interviewees felt that the TPR regime was not sufficiently directive or stringent (Box 3).

**Box 3: Interviewees' views of TPR**

*TPR was typically characterised as 'pragmatic' and 'proportionate' by research interviewees. However, some research interviewees felt that TPR's principles were too 'woolly' and that TPR relies too much on the principle that trustees will act in the best interest of pension members.*

This is related to the fact that it was felt that TPR was willing to reach agreements with organisations around how they should behave if their conduct was broadly acceptable.

**Example: positive**

This was seen to compare favourably with the FCA in terms of the treatment of savers with legacy pension schemes. While under TPR's regime trustees can move members over to a new scheme without their permission if the new scheme is judged to be better, individuals in contract-based schemes cannot be moved without giving their permission. Where pension providers do not receive this permission these members may be left in old-fashioned contracts, which might have more complex benefit structures, higher charges or fewer facilities than would be available to customers in more modern products.

**Example: negative**

TPR's approach to the 'second line of defence' where trust-based pensions only have to provide generic rather than tailored warnings to individuals intending to withdraw their DC pension savings was seen as negative. Interviewees felt that there was a greater danger that, where savers only received a generic warning, they would not always realise the implications of withdrawing their pension savings.

**The FCA has more demanding regulations than TPR in terms of firms' obligations, and there is a consensus that the FCA regime is sufficient**

There was a consensus that the FCA has more demanding regulations than TPR in terms of how regulated bodies have to demonstrate compliance with the regulations. The supervisory approaches taken by both the FCA and the PRA are more demanding than TPR's approach (in which the principal return to be submitted to TPR is the Chair's statement which confirms how they have met TPR's governance standards and, in particular, the new governance rules and charge cap). This may reflect the fact that under the trust-based regime trustees, rather than the regulator, are responsible for supervision.

Interviewees also felt that greater prescription in the FCA regulatory regime meant that there was less leeway in how they interpreted and applied rules (Box 4). Overall, there was a consensus that the FCA regime is sufficient and sustainable for regulated firms.

**Box 4: Interviewees' views around the rigour of the FCA regime**

- *Interviewees felt that FCA regulation was rigorous and sufficient.*
- *Some interviewees felt that FCA proceeded from an assumption of wrong-doing but, on reflection, suggested that this was linked to FCA being tasked to put in place a regime that minimises the risks of scams and mis-selling.*
- *While some interviewees felt that FCA's processes could be onerous there was a consensus that the cost of this type of regulatory regime is sustainable to the regulated firm or individual.*
- *Interviewees indicated that they would follow the FCA's requirements to the letter while they would take a position on TPR's guidance.*

**The FCA carries out more active monitoring of regulated individuals and organisations than TPR. The FCA regime is designed to prevent negative events while the DWP legislation addresses these after the event, with possible consequences for employers and employees**

To some degree the effectiveness of a regulator reflects the extent to which it deters activities and to what degree it intervenes at an early stage to prevent pension member detriment.

A pro-active approach where it monitors the market to identify risks to the consumer is built into the FCA's supervisory model and into its regular activities, such as the conduct of thematic reviews.

Under the trust-based regime, trustees have a legal duty to put in place internal controls,[36] and the regulator would expect to receive a 'whistleblowing' report where the implications of inadequate controls are materially significant. Trustees are personally liable and may face action where a breach has occurred. However, there is a concern that, under the trust-based regime, action takes place only once members' assets are at risk.

[36] TPR *Code of practice no.9*

These different approaches are likely to reflect differences in resource levels and the nature of each regulator's relationship with the regulated community. Interviewees felt that TPR recognises the limitations of its less pro-active regime, particularly in the context of automatic enrolment.

**Box 5: Interviewees' views around the extent to which each regulator is pro-active in addressing risks to pension savers**

- *The FCA was seen as a more pro-active regulator.*
- *Interviewees felt that TPR recognises the need to be 'on the front foot' as automatic enrolment is implemented.*

Where negative events do occur under the trust-based regime, these could have implications:

*Pension members*
- Where investments have been mismanaged or internal controls are not in place, this can lead to lower values of pension assets.
- Where a Master Trust winds up trustees would be required to cover the administration costs and, as such, these would be taken from the pension scheme funds.

*Employers*
- Where an employer enrols their employees into a pension scheme that is not managed effectively, they may have the burden of moving their employees into a different pension scheme (but has no recourse to move existing funds).

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, including that the firm is unable, or likely to be unable to satisfy claims itself, that the firm owes the claimant a civil liability and that the claimant is a person who is eligible to claim compensation. Trustees of occupational pension schemes, including schemes set up under Master Trusts, may be eligible to claim compensation, subject to the conditions in the rules being met. More information is available on the FSCS website.[37]

While earlier intervention by TPR might be more effective in protecting members' assets (for example intervening before members' assets are at risk) the cost of the type of monitoring required to enable early intervention might be beyond TPR's resources and powers.

The Master Trust Assurance Framework, developed to help trustees to assure the quality of their scheme attempts to address some of the concerns around the quality of these pension schemes. However, it is not currently mandatory for Master Trusts to complete this framework although it has been reported that TPR is considering making it mandatory.[38]

[37] www.fscs.org.uk/what-we-cover/products/pensions/?gclid=CJbmyZa3vcgCFSnkwgodNU8EXg
[38] www.engagedinvestor.co.uk/Story.aspx?storyCode=14746697&utm_source=Adestra&utm_medium=email

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

These concerns do not relate to all Master Trusts, but centre on those Master Trusts not deemed to have the scale for the mass market of automatic enrolment (with some exceptions around smaller Master Trusts designed for the top end of the market) and/or effective governance.

There are very few conditions placed on an individual or organisation starting a Master Trust, and this is likely to be why a large number of Master Trusts have been set up. It is estimated that there are up to 70 Master Trusts currently operating. This is in line with concerns, highlighted by the Office of Fair Trading, that some Master Trusts newly entered into the market in 2013 do not have the economies of scale to give value for money, and the related risk that some providers will, as a result, exit the market.[39]

This compares to the GPP market with the FCA estimating that there were only around 30 providers in 2013. The FCA product sales data suggested that 21 providers or groups of providers set up workplace personal pensions in 2013. The FCA estimated, at this time, there may have been a further 10 providers who operate GPPs.[40]

This lack of conditions to starting a Master Trust contrasts with the FCA's regulations which require that GPPs meet threshold conditions, including solvency conditions, in order to commence operating.

While interviewees stated that there were some extremely well-run Master Trusts, they also felt that this absence of conditions to entry has led to a lack of scale in some Master Trusts, with many Master Trusts being unsustainable in the longer term. It was also felt that ultimately this would lead to some Master Trusts consolidating or being wound up. This might then lead to disruption and additional work for some employers who might need to find a new pension scheme for their employees.

**Box 6: Interviewees' views around lack of conditions to setting up a Master Trust**

- *Interviewees frequently stated that 'Anyone can start a Master Trust'.*
- *Interviewees suggested that this has led to concerns around scale and sustainability of some Master Trusts, meaning that some might consolidate or wind up.*
- *There were some concerns expressed about the safety of members' pension assets.*

[39] OFT (2013)
[40] www.fca.org.uk/static/documents/consultation-papers/cp14-24.pdf

**There is a concern that a lack of transparency may lead to worse outcomes for some pension savers, under both regimes, and that TPR, in particular, has no remit to protect the integrity of the market**

Interviewees noted a move towards services, including advice, administration and fund management, being provided in a bundle via a Master Trust. While this may result in efficient provision of services in some cases, there were concerns that this might lead to conflicts of interest, for example where advisers promote their own products where this might not be in the pension member's interest. This also make it more difficult for employers to assess the value of a Master Trust's product, potentially adversely affecting value for money for the individual.

This issue has also been noted for contract-based schemes.[41] The assessment of value for money is one of the responsibilities of Independent Governance Committees (IGCs) that have recently been introduced.

Another issue for the trust-based regime, raised during interviews, is around unregulated advisers setting up some Master Trusts, something that may have an adverse impact on the market in terms of transparency and competition. This was seen as something that might not be effectively addressed under the trust-based regime, as TPR does not have a remit to promote competition and protect the integrity of the market.

In particular, there is a concern that boards of trustees will not feel able to appoint investment managers other than those linked to the adviser or provider that has sponsored the Master Trust. While a recent change in regulations by the DWP was introduced to ensure that trustees are not locked in by providers or advisers to in-house administration or investment services, some trustees may not choose to exercise this choice.

It should be emphasised that these are potential risks and it remains to be seen whether members are affected adversely by these arrangements. Moreover, there are some Master Trusts with extremely effective governance arrangements. In particular, these issues may be more likely to arise where profit is an over-riding objective for the organisations that sponsor the Master Trust.

Despite this, the recent introduction of the charge cap and governance standards indicates recognition by TPR and the DWP of the need for protection of the members' interests in the context of the pensions market. However, the charge cap does not apply to fees charged to employers.

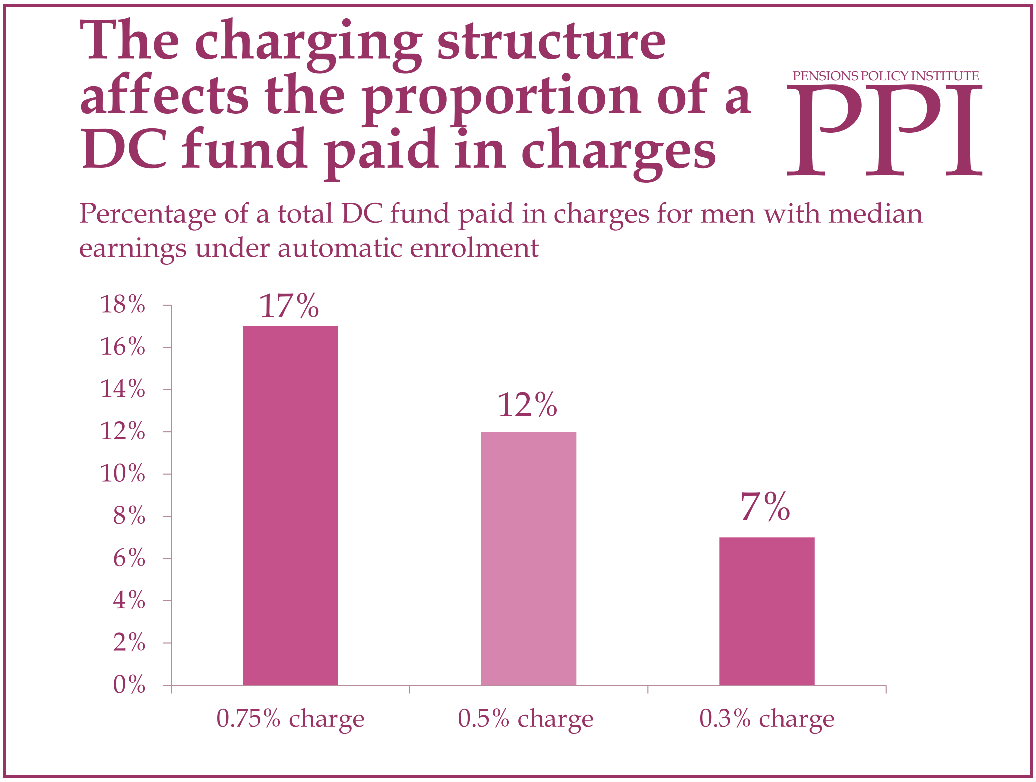
**There is a risk that some pension members may end up paying higher charges**

While it is beyond the scope of this research to assess the extent to which this will have adverse consequences for pension savers in reality, some members may end up paying higher charges under these arrangements. This is a risk for both Master Trusts and GPPs but the current trend towards bundling in Master Trusts was considered by interviewees to be a particular risk in the current regime.

[41] Office of Fair Trading (2013)

Chart 7 shows how 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.[42] This shows an adverse impact on member outcomes where there are higher charges.

**Chart 7**[43]




The level of charges is only one of a number of elements that an employer should take into account when assessing a pension scheme and its 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.

It should also be emphasised that the risks identified above, around lack of transparency, are potential risks and that there are some Master Trusts with extremely effective governance arrangements.

[42] 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. Other assumptions used in the modelling are in line with the PPIs current assumption set. These figures are based on this individual's circumstances and the outcomes will be different for other types of individuals.
[43] 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. Other assumptions used in the modelling are in line with the PPIs current assumption set. These figures are based on this individual's circumstances and the outcomes will be different for other types of individuals.

**The extent to which one of the regulatory regimes is more likely to be effective may depend on providers' motivations in making a pension scheme available**

Where the primary motivation is around providing a benefit to workers, such as in a single employer trust-based pension scheme or large not-for-profit scheme, the trust-based regime may well be effective. According to this type of model, trustees are responsible for supervising administrators and investors for the benefit of members and are motivated to do so. Moreover, the trust-based regime allows trustees the leeway to adapt their approach to the needs of employees.

However, where there may be conflicting commercial objectives, such as profit-making, the FCA regime may be more effective, in terms of working towards better outcomes for the pension member, by ensuring that organisations do not pursue other objectives at the expense of scheme members.

**The FCA's prescriptive approach to member communications may not be appropriate for work-place pensions, where the member is typically not able to choose to change pension schemes**

There is some leeway around how trust-based pensions communicate with members. In contrast, the FCA is prescriptive around the information that pension schemes have to provide to members. This reflects FCA's commitment to treating customers fairly and its objective of promoting competition in the interest of consumers. However, FCA's requirement to promote consumer choice of their pension provider may not be as relevant under workplace pensions, including automatic enrolment, where it is the employer who chooses the pension scheme.

This suggests that some of the information (such as the provision of information to help members make choices) provided may be unnecessary and restrict the development of communications which enable the reader to concentrate on the key points only.

**Box 7: Interviewees' views of information provision requirements**[44]

*It was pointed out that there is a lack of alignment between the approach to member communications taken by the FCA (in which firms have to provide sufficient information for members to exercise choice around their pension schemes) and automatic enrolment (in which it is actually the employer who chooses the pension scheme)*

As there is a contract between the pension provider and the member, the FCA requires the provider to send sufficient information to the member for them to be able to understand their pension and to exercise choice. While an individual works for an employer they are typically not able to change pension schemes without losing their employer's pension contributions. Therefore, this requirement to provide detailed information may not be sufficient to promote competition.

While individuals are typically able to choose in which fund their assets are invested, the majority of individuals typically remain in the default.

However, once an individual no longer works for a particular employer this barrier to changing pension schemes may no longer exist, and the provision of this level of information may be more appropriate.

**While competing views exist around whether there should be a single regulator, there was a consensus that combining the regulators would not be straightforward**

Workplace pensions have historically been seen as distinctive from financial services, reflecting the underlying purpose of an employer in sponsoring a pension scheme.[45] The introduction of automatic enrolment does, to some degree, represent a blurring of workplace and personal pensions, particularly where the only role of the employer is making pension contributions.

The issue of regulatory arbitrage – where a pension scheme is set up in a particular way so that it is regulated by one of the regimes rather than the other (usually the trust-based regime which is seen as less demanding) – was also mentioned by those interviewed. However, it is not clear that having a single regulator would address this to a greater degree than bringing in line some of the main causes of regulatory arbitrage such as the threshold conditions for starting a pension scheme. A further barrier would be the volume of contract, tax, trust and pension law needing to be changed to accommodate a move to a single regulator.

Research interviewees tended to favour one of the regulators taking a lead in being the single regulator, depending on their preferred approach to regulation.

[44] For example, see www.professionalpensions.com/professional-pensions/news/2285398/nest-99-of-members-in-default-fund
[45] House of Commons library (2014)

However, the interviews generated some objections to and questions about having a single regulator. These included:

- It was felt that the burden on employers should not be increased at a time when they are experiencing a high pension regulatory burden, due to the implementation of automatic enrolment.
- It was not clear where a single regulator should sit – whether this would be in the DWP or Her Majesty's Treasury's (HMT) remit.

**There are concerns around individuals, organisations and products that are not regulated**

Both desk research and interviews with experts drew attention to risks brought about by those individuals, organisations and products that either fall outside the regulatory regimes, or have not applied for authorisation when they should be regulated (Box 8). In particular, concerns were expressed about the use of unregulated investments by Master Trusts and the risk posed by these to member outcomes. However, in practice Master Trusts are bound by the requirement to invest predominantly in regulated markets.

**Box 8: Unregulated Collective Investments Schemes**[46]

The FCA reports that Unregulated Collective Investments Schemes cannot be promoted to the general public but, in fact, the FCA has seen evidence that these are being sold to the individuals.

**It was felt that any failure in pensions regulation would be felt by the whole of the industry**

If one of the regulators was not successful in preventing member detriment, it was felt that the reputation of the pensions industry as a whole would suffer and, for this reason, the effectiveness of the regulators is important across the board.

[46] www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/ucis

# Chapter four: considerations for employers

While many employers may be able to use their existing pension scheme for automatic enrolment, others are required to choose one. To date, employers have typically opted for a Master Trust or a Group Personal Pension (GPP). Employers' objectives for their pension scheme will influence which type of scheme is appropriate for them. This chapter makes comparisons between GPPs and Master Trusts that might be relevant to this decision.

Single trust-based pensions could represent an opportunity for those employers who wish to play a central role in their workforce's accumulation of pension assets. However, it is thought that few employers will opt for a single employer trust-based pension due to the burden that this represents in terms of appointing trustees and, in turn, the high level of responsibility borne by the trustees.

In contrast, both GPPs and Master Trusts generally cost less and require lower levels of employer involvement.[47] Therefore, the remainder of this chapter focuses on the choice between a GPP and a Master Trust.

Where employers choose either a GPP or a Master Trust, they are opting for a model of pension provision and the associated regulation regime. While regulation is unlikely to be the primary consideration, it may have implications for pension members' outcomes.

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 accepting all employers.
- Overall, there is a charge cap for the default funds used by providers for automatic enrolment; however, this does not take into account any fees charged to employers.

Table 2 provides some comparisons between GPPs and Masters Trusts. There are some distinct differences between GPPs and Master Trusts in terms of some of the criteria. However, there will also be some scheme and employer specific characteristics, such as current administration and payroll systems, that employers will need to consider.

[47] TPR (2015)

**Table 2: 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 retirement savings. As GPPs provide individuals with more tailored information as they approach retirement, in particular, this regime may help those in making choices about the management of their savings.<br><br>However, to fully support those wishing to make personal choices, employers may need to put in place additional measures such as communications. |
| Cost | Charges for the default fund used for automatic enrolment are subject to the charge cap. However, employers should take into account other charges, such as transaction charges and charges payable by the employer. | |
| Value for money | Any costs should be weighed against benefits provided by the scheme; these could be in terms of areas such as quality of employee communications and management of funds. | |
| Governance structures | Rules provide for Master Trusts to aspire to excellent governance structures that have a knock-on effect on areas such as quality of investments and administration. 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 effecting at avoiding adverse events. | The more pro-active FCA regime may be more effective at avoiding adverse events. |

Overall, the Master Trust regulations alongside TPR's pragmatic approach can encourage and enable Master Trusts to develop excellent governance structures. However, this depends on the intentions of trustees and may be less effective in addressing issues around low quality Master Trusts. For this reason, employers may wish to assess the quality of the Master Trust.

It is not yet possible to know the exact implications of negative events, such as being wound up, for Master Trusts. However:

*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 and, as such, these would be taken from the pension scheme 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.

For these reasons, employers may wish to make their own enquiries or may be happy to accept industry standards such as the Master Trust Assurance Framework or The Pension Quality Market as evidence of quality.

In contrast, the checks in the FCA's regime are well-suited to avoiding pension member detriment but may not facilitate the provision of excellent pension schemes to the same degree as the trust-based regime.

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, including that the firm is unable, or likely to be unable to satisfy claims itself, that the firm owes the claimant a civil liability and that the claimant is a person who is eligible to claim compensation. Trustees of occupational pension schemes, including schemes set up under Master Trusts, may be eligible to claim compensation, subject to the conditions in the rules being met. More information is available on the FSCS website.[48]

[48] www.fscs.org.uk/what-we-cover/products/pensions/?gclid=CJbmyZa3vcgCFSnkwgodNU8EXg

# Conclusions

**Particular aspects of workplace pensions mean that there is a need for regulation**

Complexity of pension arrangements, the need for specialist management and the fact that outcomes may not be apparent for some years mean that it is difficult for members to assess whether they are receiving value for money. This results in the need for external regulators to ensure that members are treated fairly and have access to strategies that best suit their needs.

**TPR's role in ensuring that employers make contributions should not be underestimated, with interviewees rating its communications with employers as good and appreciating its pragmatic approach**

As inadequate pension savings constitute the highest risk to adequate retirement income, TPR's role in ensuring that employers make contributions is a large, complex and valuable one. Both employers and advisers rate TPR's communications.

**Both regulators have strengths that could helpfully inform approaches taken by the other regulator**

TPR's strengths lie in its pragmatic approach that makes it relatively easy for trustees to comply with the regulations and the leeway that it allows pension schemes in terms of communication with members.

The FCA's regime is more robust, and designed to prevent adverse events; this approach may be particularly valuable in terms of emerging priorities, under the Master Trust regime, around the prevention of adverse events.

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

These concerns do not relate to all Master Trusts, but centre on those Master Trusts not deemed to have the scale for the mass market of automatic enrolment.

It is not yet possible to know the exact implications of negative events, such as being wound up, for Master Trusts; however, these could be lower values of pension assets and disruption where they are moved to another provider. Employers may pay higher charges than necessary to advisers who are unregulated (the charge cap does not apply to fees paid by employers).

**New regulations and the introduction of the Master Trust Assurance Framework (although not mandatory) represent a move towards a more stringent approach for trust-based pensions**

A charge cap and governance regulations were introduced from April 2015 for trust-based pensions, although the charge cap applies to both GPPs and trust-based pensions used for automatic enrolment.

The Master Trust Assurance Framework, developed to help trustees to assure the quality of their scheme attempts to address some of these concerns. However, it is not currently mandatory for Master Trusts to complete this although it has been reported that TPR is considering making it mandatory.[49]

**There is a concern that a lack of transparency may lead to worse outcomes for some pension savers, under both regimes, and that TPR, in particular, has no remit to protect the integrity of the market**

Interviewees noted a move towards services, including advice, administration and fund management, being provided in a bundle via a Master Trust. While this may result in efficient provision of services in some cases, there were concerns that this might lead to conflicts of interest, for example where advisers promote their own products which might not be in the pension member's interest. This also makes it more difficult for employers to assess the value of a Master Trust, potentially adversely affecting value for money for the individual.

This issue has also been noted for contract-based schemes.[50] The assessment of value for money is one of the responsibilities of Independent Governance Committees (IGCs) that have recently been introduced.

However, a particular issue around the trust-based regime, raised during interviews, is around the role of unregulated advisers in setting up some Master Trusts and the fact that TPR does not have a remit to promote competition and protect the integrity of the market.

**While competing views exist around whether there should be a single regulator, there was a consensus that combining the regulators would not be straightforward**

The issue of regulatory arbitrage was raised during this research. However, it is not clear that having a single regulator would address this to a greater degree than bringing in line some of the main causes of regulatory arbitrage such as the threshold conditions for starting a pension scheme.

[49]www.engagedinvestor.co.uk/Story.aspx?storyCode=14746697&utm_source=Adestra&utm_medium=email
[50] Office of Fair Trading (2013)

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