

Consultation document

How the Pensions Regulator will
regulate defined contribution schemes
in relation to risks to members

13 November 2006

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Foreword

Our statutory remit recognises that the identification and mitigation of risk is important in any form of work-based pension provision. Although much recent public, industry and indeed regulatory focus has inevitably centred on defined benefit (DB) funding issues, our medium term strategy commits us to ensuring that risks to members of defined contribution (DC) schemes are also highlighted and addressed in a proactive and proportionate way. This also links directly to another of our key strategic aims to improve the governance of work-based schemes overall.

In looking at defined contribution schemes and the risks to members, we have focused on all work-based schemes, whether they have trust-based or contract-based arrangements. Our proposed approach focuses on:

- **Education:** we have already done a lot of work in this area in developing guidance and codes of practice, in building up trustee knowledge and understanding, and in launching a number of e-learning modules. We propose to build on this by publishing practical guidelines based on existing good practice.
- **Partnership working:** we already have strong relationships in place with other regulatory bodies and the pensions industry more widely. We propose to build on these to ensure that our proposals can be implemented consistently and to ensure that a coherent and holistic view is taken in respect of new risks and mitigating activities.
- **Intervention:** we also propose to act decisively where there are persistent or significant failures that result in poorly managed schemes or which put members' benefits at risk.

We are publishing this consultation document at the same time as we launch a specific e-learning module focused on DC schemes. This underlines our commitment to continue to work with trustees to ensure that they are able to act in the best interests of scheme members. We have already had exceptionally positive feedback from trustees welcoming this new learning tool and we intend that it will go from strength to strength.

Your views are important both to us and to DC scheme members, and I encourage you to respond to this consultation. The consultation process will last for 12 weeks running from 13 November 2006 up to, and including, 2 February 2007.



Tony Hobman
chief executive, the Pensions Regulator
13 November 2006

Executive summary

The Pensions Regulator's aim for DC schemes, as set out in our Medium Term Strategy, is that:

Trustees and others involved in running defined contribution schemes (such as providers, administrators and employers) will have a clear understanding of the significant risks inherent in such arrangements, especially in relation to administration, member awareness and investment, and how they should be mitigating them.

We have identified the key risks that are common across DC schemes as:

- poor administrative practices;
- poor investment practices;
- unduly high charges;
- poor decisions on retirement choices; and
- lack of member understanding.

It is important to set our responsibilities in context in this area.

Whereas for DB schemes the main risks rest with the employer, in DC schemes most risk is transferred to the individual. It is very important therefore that individuals understand the critical issues they need to consider in order to make decisions: in relation to deciding whether to participate in a DC scheme, what contributions to make, investment choices and, ultimately, what annuity options to take.

There are a number of organisations involved in regulation of the DC landscape. As well as the Pensions Regulator ('the regulator'), the FSA and DWP also have key roles in the decisions that individual members will take. Each has an important role to play in enhancing members' interests and improving understanding and choice: for example through the DWP's objectives to encourage take-up, the FSA's aim of promoting financial capability, and the Pensions Regulator's direct focus on ensuring that those running and providing DC schemes understand how the scheme should be run so as to reduce risks to members.

Whilst an emphasis on partnership working is an important theme of our work, it is also key for the regulator to deploy resources to best effect in support of our statutory objectives, and we have therefore set out our proposals in this document to reflect that focus.

We recognise that many schemes are well run, and welcome the innovations in the market place to raise standards in the DC environment, for example the creation of governance committees for contract-based schemes. However, there is still room for improvement and this view has been supported by our governance survey report on occupational pensions.

As a risk-based regulator we have focused not only on risks that may already exist but also on those that may materialise in the future. Our aim will be to influence behaviours so as to reduce the likelihood that risks will materialise and to act decisively where they do.

The approach we will take to regulating DC schemes will therefore be proportionate to our evaluation of risk. The membership of DC schemes totals around 5 million members, with the vast majority of occupational schemes including fewer than 12 members (approximately 88 per cent of occupational DC schemes, yet representing less than 1 per cent of the members of these schemes; figures for contract-based schemes are not included). Because of the demographics of DC schemes, a key focus of our approach is on prevention through education. We will intervene, however, where persistent or significant failures are identified.

Our proposals centre around:

- **Education and guidance:** combining existing initiatives – including our e-learning modules as part of the Trustee Knowledge and Understanding (TKU) framework and codes of practice – with new initiatives, such as the publication of tailored practical guidance and expansion of our website.
- **Partnership working:** working with government, other regulatory partners and industry through working groups and other channels, as appropriate, to develop good practice guidance, identify future initiatives and ensure a consistency of approach where there is some overlap of roles.
- **Intervention:** by taking decisive action where poor practice is carried out on a significant or systemic basis and has a major impact on members' benefits. For example, we will be prepared to use our powers by publicly reporting parties ('naming and shaming') where appropriate.

Whilst we have many regulatory tools at our disposal to use if the need arises, including the ability to replace trustees and to issue third party or improvement notices, we expect our focus to be mainly on the following:

- **Publication of good practice guidance:** developed with industry partners, this will set out the standards expected of well run schemes. It will cover each of the five risk areas, and will be aimed at trustees, managers, employers and providers (depending on whether the scheme is trust-based or contract-based). We expect that it will also be useful for Third Party Administrators (TPAs) and payroll providers so that they understand expected standards of service.

- **Publicly reporting advisers and service providers** (for example, through ‘naming and shaming’) as appropriate, where a consistently poor service is being provided, and reporting to professional associations and institutes.

We believe that through this approach, those who run and provide trust-based or contract-based DC schemes will understand and implement good practice within their schemes, so that:

- risks can be prevented from materialising on a large scale;
- pension schemes provide value for money to members; and
- members’ understanding is improved so that they can understand their pension scheme, the decisions to be made and what those decisions mean for them.

We will assess the impact of the activities that are taken forward as a result of this consultation process and will continue to work with government, other regulatory and industry partners on identifying and addressing future needs.

What we ask of consultees

We would like consultees to consider the current pension environment and how DC schemes fit into it.

We would value evidence-based views on the extent to which schemes are currently run as effectively and efficiently as possible and whether the risks, as outlined in this document, are the right ones to have focused on.

We would welcome suggestions that support the activities we have outlined within this consultation document.

We also seek views on the following broad areas:

- whether you consider that the main risks and issues outlined for the regulator to address have been identified;
- what priority you believe should be given to addressing the risks and issues identified; and
- whether the proposed approaches and interventions will provide an effective and appropriate regulatory response from the Pensions Regulator.

The DC environment

DC arrangements

Broadly speaking there are two types of DC arrangement:

Trust-based arrangements

Trust-based schemes are arrangements between the employer and the trustees, with the trustees looking after members' interests in relation to how the scheme is run.

Regulatory responsibility for trust-based arrangements falls to the regulator.

Contract-based arrangements (including stakeholder pensions)

Contract-based arrangements consist of individual personal pension policies owned by the members. They are schemes provided by insurance companies, friendly societies etc. The terms of the arrangement will be outlined in a contract between the member and the provider (not the employer). Essentially the contract will outline the terms of agreement between the two parties with the member authorising the collection and investment of contributions by the provider – a primary feature of the agreement. The employer may be involved only as far as selecting the provider, promoting the scheme to employees, determining the contribution level, ensuring contributions are paid and passing details of members to the provider or administrator.

Regulatory responsibility for contract-based arrangements is shared between the regulator and the FSA. The regulator is primarily concerned with ensuring the good administration of work-based schemes and protecting members' benefits. The FSA regulates the sales and marketing of personal pensions (including stakeholder pensions) and annuities. It is also responsible for the prudential regulation of the firms who provide these pensions and annuities and, from April 2007, it will also be responsible for regulating the establishment, running and winding up of personal pension schemes including self-invested personal pensions (SIPPs).

Trust-based and contract-based arrangements relating to work-based DC schemes are covered in this document, as we need to ensure member protection and to promote good administration of both types of scheme. Appendix 1 sets out the interests of the regulator and the FSA in relation to the different types of scheme and different groups of professionals.

Figures a-d below provide some basic summary data on the size and composition of the DC market.

Figure a: Size of DC market (trust-based and contract-based arrangements)

Scheme type	Number of live schemes	Number of members of live schemes
Trust-based DC Occupational Pensions (1)	72,000	2,700,000
Group Personal Pensions (2)	100,000	1,900,000
Group Stakeholder Pensions (2)	34,000	680,000
<i>Totals</i>	206,000	5,280,000

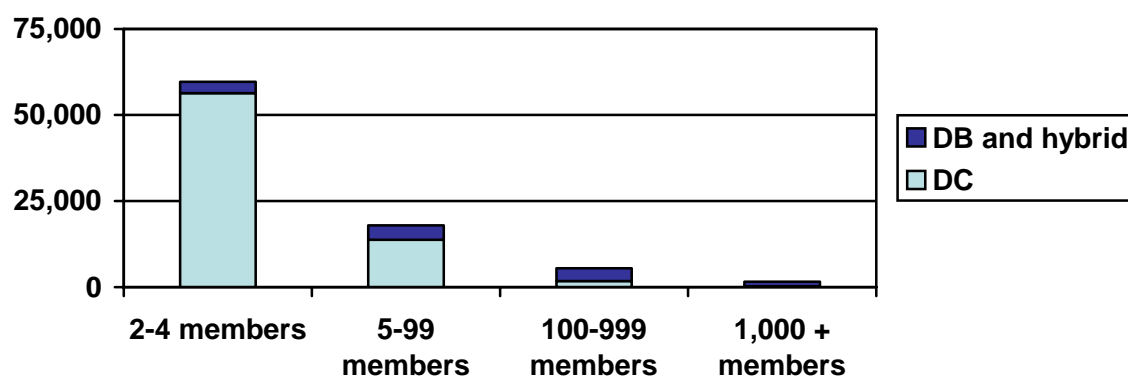
(1) based on Opra registry data, March 2005

(2) estimate based on extrapolated data from seven of the top ten providers, August 2006

Profile of wider pension scheme membership

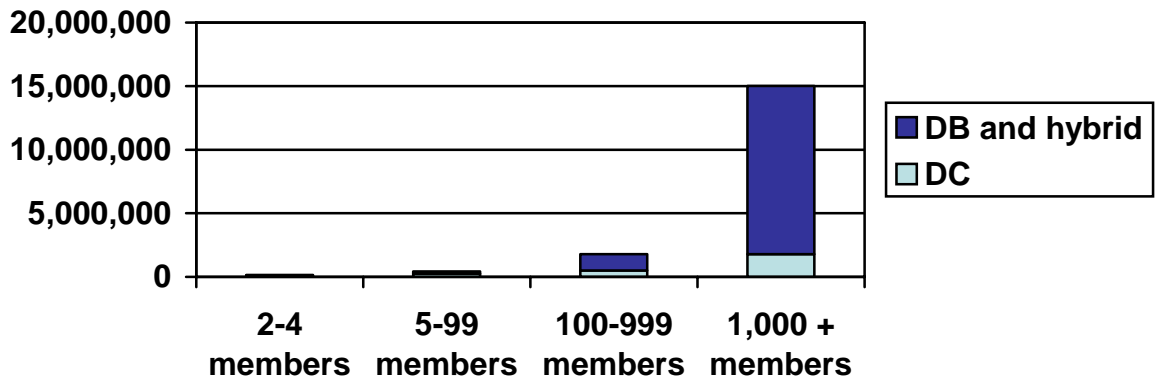
As at 31 March 2005 there were some 17.3 million members of approximately 84,600 private sector occupational pension schemes – broken down as in figures b and c below. Over 85 per cent of these members belonged to just 1,600 schemes with 1,000 or more members. These 1,600 schemes comprise just 1.9 per cent of all schemes: 1,300 are DB or hybrid and 300 are DC (including both trust-based and contract-based schemes).

Figure b: Number of 'live' private sector occupational schemes, by registered benefit type



Source: the Pensions Regulator, *Pension schemes in the UK, 2005*

Figure c: Numbers of members, by registered private sector occupational scheme benefit type



Source: the Pensions Regulator, Pension schemes in the UK, 2005

Of the approximately 83,000 schemes with fewer than 1,000 members, some 72,000 were occupational DC schemes and 11,000 were DB or hybrid. Of the 72,000 DC schemes, approximately 65,000 had between two and eleven members (see figure d below).

Figure d: Size and number of occupational DC schemes

Size of scheme (number of members)	Number of DC schemes
2 – 11	64,275
12 – 99	6,356
100 – 999	1,783
1000 – 4999	231
5000 – 9999	33
10000 +	22
<i>Total</i>	72,700

Source: the Pensions Regulator, Pension schemes in the UK, 2005

These tables show that DC membership is already significant.

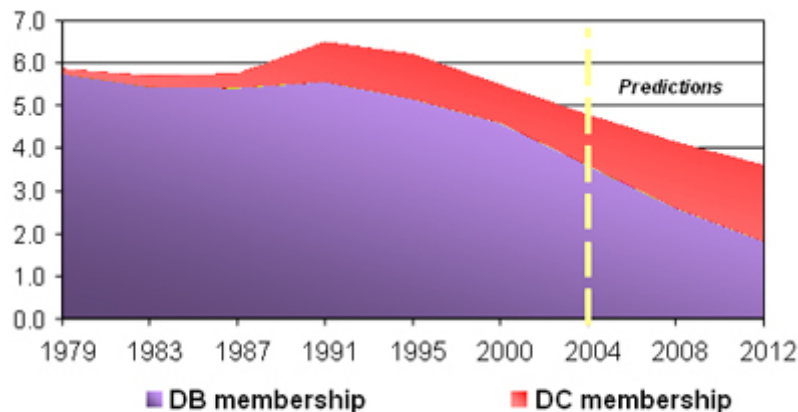
Changes in the landscape

Shifts from DB to DC provision

The closure of many DB schemes to new members, coupled with the associated move towards DC provision, is well understood. An estimated 54 per cent of DB schemes closed to new members between the end of 2001 and the end of 2004.¹ By October 2005 only 24 per cent of FTSE 100 companies offered DB schemes to all new employees and 67 per cent did not offer DB schemes to any employees.² Of those that did not offer a DB scheme to an employee, 74 per cent provided a trust-based DC scheme instead, and 14 per cent a contract-based GPP scheme.

Despite the current rate of decline of active DB members, such schemes will remain prominent for many years to come. If current trends continue, there will be broadly equal numbers of active members in DB and occupational DC schemes by 2012 (as shown in figure e below).

Figure e: Active membership in private sector occupational schemes (millions)



Source: Data GAD Survey / DWP 'Shifts in the Pensions Landscape'

Predictions added based on rate of change from 2000 to 2004

By 2012 active members of occupational schemes split 50:50 DB / DC?

¹ NAPF survey figures 2005.

² *Sunday Telegraph* survey of FTSE 100 companies, October 2005.

DC OPS to contract-based DC

Along with the trend for employers to provide DC rather than DB schemes, there is also a shift occurring within the DC environment from trust-based schemes to contract-based schemes. For example, recent research estimates that Group Personal Pension (GPP) arrangements cover eight per cent of working people.³ There is also some evidence that this trend may accelerate: one survey said that, while only two per cent of trust-based DC schemes intended to switch to GPPs or stakeholder arrangements in the next year, 11 per cent were undecided whether to do so.⁴ Several large employers have recently closed their DB pension schemes and replaced them with contract-based DC arrangements.

These changes have brought DC (and in particular contract-based DC) schemes firmly into the spotlight – resulting in a number of initiatives across the industry to raise standards. For example, some contract-based schemes are putting in place governance committees.

Although the trend is still in its infancy and it is difficult to obtain specific data, it is recognised within industry that contract-based DC schemes are becoming an increasingly common investment vehicle in the emerging pensions landscape. The features of trust-based and contract-based schemes are described in Appendix 2.

Personal accounts

On the horizon is the Government's introduction of personal accounts in 2012. These are a style of DC scheme designed to complement rather than to replace existing pension schemes, and to reach the employees of those employers who do not currently have pension arrangements.

Changes planned from April 2012 will affect existing DC schemes in a number of important respects, for example the requirements to automatically enrol all employees and a mandatory employer contribution. A particular ramification of the introduction of personal accounts is that there will be an even higher expectation that schemes are well run, particularly since auto-enrolment is based on the assumption that it is likely to be in most members' interests to join.

We are working closely with the Department for Work and Pensions on their proposals for the introduction of personal accounts, and anticipate that the activities taken forward as part of this consultation will go some way towards complementing and supporting their introduction.

³ National Association of Pension Funds, *Pension Scheme Governance – Fit for the 21st Century*.

⁴ Capita Hartshead, 12th Pension Scheme Administration Survey, 2005.

Chapter 1: Overview of proposed approach

Clearly there are risks in all pension schemes: however, this document focuses on those risks relating to DC schemes, some of which fall within the regulator's responsibility and some of which do not. In essence the provision of a DC, rather than a DB, arrangement moves most of the risk from the employer to the individual.

In making decisions about whether to save for a pension or not and, if so, how much to put in, the individual will need to consider competing financial needs and their appetite for taking investment risks. These are key issues in the DC landscape that will need to be addressed by a number of parties, including government and regulators. For example, the DWP has a role to play in providing information on pensions to encourage take-up, and the FSA has a role in promoting public awareness of the financial system. The provision of this information can help individuals take informed decisions. The regulator's aim is to work in partnership with these bodies, but then to focus more fully on encouraging and enforcing good practice in those schemes that exist to enable us to achieve our statutory objectives of protecting members' benefits and promoting good administration.

The overarching risk from the regulator's perspective is that trustees, employers, providers, advisers, administrators and payroll providers fail to understand the complexities and risks involved in providing and running DC schemes, or to give DC risks the attention they require.

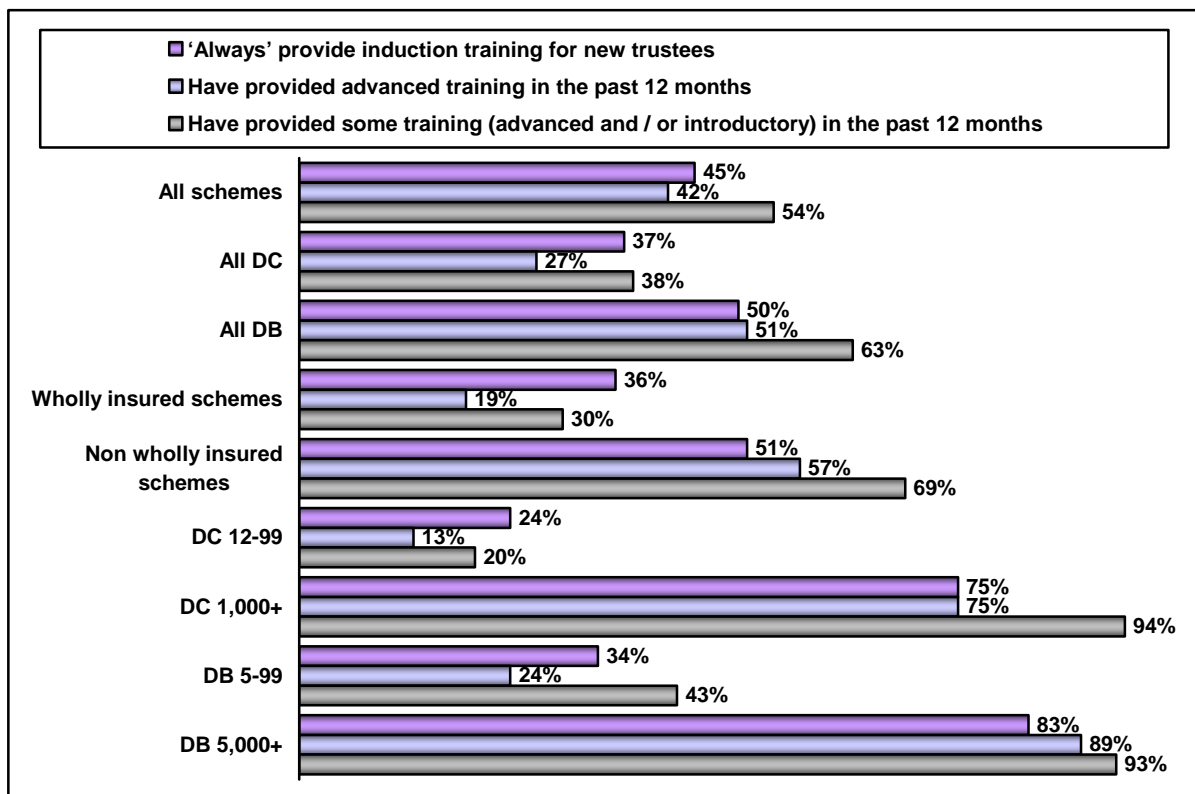
Deficiencies in knowledge and understanding on the part of those running DC schemes reflect the fact that:

- much of the focus of the industry, particularly in occupational schemes, has been on DB schemes until relatively recently, meaning that there may be less help and support available to trustees and managers of DC schemes; and
- the large majority of DC schemes are small, and resources to engage experienced advisers may be difficult to find.

Our first and top priority therefore is to promote the raising of standards, clarifying what is expected of those running and providing DC schemes and backing this up with action where necessary.

In relation to trust-based schemes our recent governance survey showed that, of those pension schemes surveyed, there was a split between schemes that were committed to training and those that did little or nothing. For example, on induction training, 35 per cent of all schemes surveyed 'rarely or never' offered it. In respect of other training, the statistics were even worse and showed that from 41 per cent of all schemes surveyed no trustees had had any formal training in the past 12 months. When looking at all DC schemes this figure increased – particularly in relation to the smaller schemes – thus reinforcing the message that education and training is an essential requirement for these schemes in particular and the DC sector in general. Figure f below illustrates the provision of training for all schemes included in the survey.

Figure f: Provision of training for trustees



Base: interviews with trustees representing 500 schemes (unweighted), 9,901 schemes (weighted)

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

It is clear from the table above that the provision of induction and ongoing training is not standard practice within the majority of trust-based schemes.

Where training was provided, however, the results showed a marked increase in the confidence of trustees in their own performance and in demonstrating a higher standard of scheme governance. This clearly shows the positive impact that training can have on the management of a pension scheme, as shown in figure g below.

Figure g: Trustees 'strongly agreeing' that the board performs in four selected areas

	All schemes: column percentages			
	All schemes	Advanced training in the last 12 months	No formal training in the last 12 months	Difference in percentage points
Regularly reviews its investment strategy	62	84	41	+43
Reviews the scheme rules at regular intervals and updates these as required	55	72	42	+30
Takes steps to ensure it follows good practice in governance	67	81	52	+29
Ensures a high standard of member communications	36	49	22	+27

Base: interviews with trustees representing 500 schemes (unweighted), 9,901 schemes (weighted)

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

The regulator has already gone some way towards addressing the issue of training and education with the ongoing development of the trustee toolkit as part of our Trustee, Knowledge and Understanding (TKU) framework and the publication of codes of practice and guidance. To underline this, we have today published an e-learning module on DC schemes that includes information on the risk areas outlined in this document. The education proposals set out in later chapters are intended to supplement that e-learning module as well as being tailored to wider audiences.

As well as the TKU framework we have put in place, we recognise that there are a number of other organisations within industry with a remit that includes improving how schemes are managed, with whom we intend to consolidate our partnerships as a means of better communicating key messages and identifying new approaches to mitigating risks.

We therefore intend to take a three-pronged approach to support those involved in running both trust-based and contract-based DC schemes by:

- education and guidance (mainly through the dissemination of good practice guidance);
- partnership working; and
- intervention.

Education and guidance

As indicated earlier, we have already made a start in providing education and guidance in relation to DC schemes through the publication of our codes of practice and the e-learning module as part of our TKU framework. (Further details of our current regulatory response can be found in Appendix 3.) We will supplement existing guidance by providing further practical guidance on the standards that the regulator expects in relation to the good administration of pension schemes and protecting members' benefits.

The main educational tools we propose to develop are:

- Good practice guidance, delivered over the web, developed with industry partners and tailored to different audiences as appropriate covering the five risk areas, which will include:
 - examples of good practice within the industry;
 - templates covering items such as service level agreements (SLAs) between those running schemes and service providers; and
 - examples of effective communications from those running and providing schemes to scheme members.
- Enhancements to our website, to include:
 - links to support and complement existing initiatives within the industry, for example, linking to relevant tools such as the FSA's cost comparison tables and support for scheme members, such as the FSA's annuity comparison tables.

Subject to the outcome of this consultation, we will begin work on developing the guidance and enhancing the website once this consultation ends in the new year.

Partnership working

Central to the delivery of our proposals is the need to work in partnership with government and other regulatory and industry partners, to identify ways in which we can either support the activities already taking place or provide additional help to ensure consistent messages and support.

We plan to work with these partners through appropriate channels, for example working group forums, in order to identify how we can best co-ordinate our efforts.

Intervention

The regulator's risk-based approach involves a system of prioritising resources to address those risks to members' benefits which have the greatest impact and / or probability of occurring.

This approach ensures that:

- the regulator takes a more proactive approach to intervention;
- the regulatory burden on schemes is reduced, thus demonstrating efficiency and cost-effectiveness to levy payers and government; and
- the regulator maximises its impact on outcomes and behaviours.

We will seek to focus any interventions on those DC schemes that pose most risk to the regulator's objectives of protecting members' benefits and ensuring good administration of pension schemes. Intervention will be proportionate to the level of risk.

Where we receive reports of significant and / or persistent problems in services provided to trustees by advisers or third parties we will consider taking action through public reporting ('naming and shaming') and reporting to the relevant professional trade bodies and institutes. We will also encourage the use of whistleblowing reports, and will issue third party notices and improvement notices where appropriate.

Addressing the risks

This chapter has detailed our high level approach to how we plan to address the risks. Chapters 2–6 provide more detail on the issues involved, the mitigating actions that can be taken and where the regulator will intervene.

Questions

Do you agree that the main risks and issues have been identified? If not, please provide views on where you think other significant risks occur.

Do you consider that certain risks should be given a higher priority than others? If so, do you have experience of these risks occurring within your pension scheme, or a scheme of which you have knowledge?

Do you agree with the proposed high level approaches and interventions, and do you think that they address the risks? If not, please provide your views and any alternative suggestions.

Chapter 2 – Addressing the risks: poor administrative practices

Summary

Objective: that trust-based and contract-based schemes are well run, that adequate internal controls are in place to ensure they continue to be well run and that parties communicate with each other to ensure accurate and timely record keeping and reconciliation of contributions.

We will provide support by:

- publishing good practice guidance, tailored to the relevant audience, to include:
 - examples of service level agreements covering both administration and payroll items (to be used as benchmarks of the standards the regulator expects) using existing standard templates within industry as a starting point;
 - examples of internal control processes, including risk management processes; and
 - examples of timely disclosure, communication products and campaigns that have proved to be effective within the industry.

We expect that:

- service level agreements will be put in place between trustees, managers, pension providers and their service providers (administrators / payroll providers), to ensure administration can be monitored and maintained;
- robust internal controls are in place to support administration procedures, including risk management processes;
- where administration is provided in-house, appropriate performance levels and internal controls are put in place; and
- accurate, timely and relevant communications take place between parties – including members – to ensure accurate and timely record keeping.

We will intervene by:

- publicly reporting those firms which persistently demonstrate poor administration practices or where the failure is significant – including third party administrators and payroll providers where appropriate;
- considering the appointment of the trustee where they fail to ensure good administration practice is carried out or to put in place steps to improve it; and
- issuing third party or improvement notices where appropriate where poor practice results in a breach of pensions legislation.

Introduction

Administration activities for the purposes of this consultation document include: setting up and maintaining member records; dealing with membership movements; reconciliation procedures in relation to ensuring the right contributions are paid for the right person; providing appropriate disclosure to members; and calculating and making benefit payments.

Ensuring a pension scheme is run in the most effective and efficient way is crucial to protecting members' benefits.

Administration is inherently more complex in DC schemes than in DB schemes and it is important that all parties (trustees, employers, administrators, payroll providers) understand the different complexities, particularly where DB rather than DC provision has been previously provided. The main differentiating feature of DC administration is that each member's investment choice has to be set up individually; this is time consuming and poses more risk of error. DC schemes also involve complex banking and accounting processes, where the timeliness and accuracy of the payment and allocation of contributions is essential in order to ensure that the correct fund value is attributed to individual members and the pension fund builds up in the way expected.

Administration and payroll services are increasingly being outsourced and provided by third party administrators (TPAs) or separate payroll providers. Our recent governance survey of occupational pension schemes showed that 66 per cent of trust-based schemes surveyed use a firm of TPAs, whilst 17 per cent use the services of the scheme insurer. This means that in order to maintain high standards of administration, the trustees, and other parties running pension schemes, need to manage closely the relationship with those providing such services.

This is usually achieved through a service level agreement (SLA) that ensures administration and controls are considered as a matter of policy, although our governance survey showed that around 25 per cent of trust-based schemes surveyed either had no SLA in place with their service provider or at least were not aware of any such agreement.

Our governance survey also showed that trustees are generally confident in their ability to manage administration providers and are largely satisfied with the standards of administrative services they receive across a range of measures including accuracy, member satisfaction and timeliness. However, the survey found that the higher satisfaction ratings were among larger DB schemes, with smaller DC trust-based schemes having the lowest satisfaction ratings. This issue is further highlighted by the fact that our survey also showed that 36 per cent of all DC schemes surveyed had not reviewed their administrative services in the last three years (see figure h below).

We will also be working to ensure that, where administration is provided in-house, it is provided so as to meet the regulator's expectations.

Figure h: Schemes carrying out formal reviews at least every three years: differences by scheme size

Review Topic	All DC trust-based and segregated schemes			
	All schemes	12-99 members	100-999 members	1,000+ members
Appropriateness of investment choices offered to members	75%	61%	89%	90%
Performance of investment funds offered to members	76%	65%	88%	91%
Level of fund charges	75%	67%	82%	88%
Administrative services for individual members with DC benefits	64%	59%	71%	63%

Base: interviews with trustees representing 251 DC and segregated schemes (unweighted), 4,461 DC and segregated schemes (weighted)

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

Key issues which contribute to poor administration

DC provision for both trust-based and contract-based schemes is complex and the fact that it is generally managed by a third party adds to the potential for administrative errors on a systemic basis, for example in the transfer of data between parties or that errors may go unnoticed for a period of time. The key issues we have identified that could result in a negative impact on members' benefits are:

- inadequacies or errors in reconciliation procedures;
- irregularities, or delays, in payment of benefit;
- inadequate information flows; and
- lack of effective service level agreements / review procedures with TPAs and payroll providers.

Inadequacies or errors in reconciliation procedures

For example:

- inaccurate / poor recording of employee data;
- delays and inaccuracies in setting up fund choices; and
- failure to document changes to members' salary records accurately.

Irregularities, or delays, in payment of benefit

For example:

- benefits paid to the wrong person or to the wrong account / address due to inaccurate records;
- incorrect levels of benefits paid; and
- late payment of benefits.

Inadequate information flows

For example:

- lack of adequate information to members;
- lack of information from members to administrators, for example, relating to changes to member details; and
- disparity between what a member expects by way of service and what the administrator thinks is adequate.

Lack of effective service level agreements / review procedures with TPAs and payroll providers

For example, where a third party administrator is used, our governance survey showed that around one in five of the trust-based schemes surveyed did not have an SLA in place.

There is currently no one body regulating TPAs and payroll providers. To date the regulator has had dealings with TPAs on individual cases, but in view of the increasing number of schemes using third parties for the provision of services we are reviewing the way in which we interact with these audiences going forward, as outlined in this document.

Internal controls are required to ensure that SLAs in place continue to be monitored, standards maintained or increased, and risks identified and addressed. Our governance survey showed that formal risk management processes are only common among the largest trust-based schemes and of those DC schemes surveyed only 33 per cent had formal processes in place (see figure i below).

Figure i: Trust-based schemes with formal processes in place to identify risks

All DC	33%
DC 12-99	24%
DC 1,000+	51%
10,000+ members (DB and DC)	85%

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

Expected outcomes and how to achieve them

The outcomes we want to achieve are:

- the promotion of good administration within trust-based and contract-based pension schemes;
- the implementation of robust internal control processes (including risk management processes) to ensure schemes are monitored and continue to be well administered; and
- effective communication between relevant parties, including members, so that, as far as possible, accurate and timely record keeping, reconciliation of contributions and payment of benefits can be achieved.

We propose to achieve these outcomes through a combination of existing regulatory tools and new initiatives.

Existing tools

Currently we are seeking to help in this area through:

- providing access to our e-learning module on DC schemes;
- signposting our codes of practice on reporting breaches and internal controls with supporting guidance on compliance with the requirements of pensions legislation; and
- taking appropriate and proportionate action where whistleblowing reports are received, for example, where non or late payment of contributions has been reported and not rectified.

The way forward

How we will provide support

Education and guidance

We will help trustees, managers, employers, providers, third party administrators and payroll providers by publishing good practice guidance, following the consultation exercise, which will include:

- examples of SLAs covering both administration and payroll items – to be used as benchmarks and to help ensure that administration is addressed as a matter of policy (for example record keeping, reconciliations, making payments, disclosure of information and two-way communication with members). There are already standard SLAs within industry that will provide a good starting point for discussion with industry partners

- examples of internal control processes (including risk management processes) and how they should be used in relation to an SLA to ensure that administration and payroll processes continue to be appropriate, standards maintained and risks identified;
- examples of effective data transfer processes (for example, in the event of a change in administrator or payroll provider);
- examples of how member understanding can be raised in relation to the service they should expect from those parties providing administration and payroll services (for example how and when they can expect to receive information). This activity will also help to raise service standards if members understand what they should be receiving as they will be encouraged to let trustees, providers and employers know when they are experiencing problems;
- examples of timely disclosure and communication products and campaigns that have proved to be effective within the industry; and
- examples of good communication methods and exercises to support the exchange of information between parties.

What we expect

It is crucial that standards of administration are raised and the regulator expects trustees and, where appropriate, managers, providers and employers, to:

- include SLAs and internal controls in contracts with service providers that reflect good practice in ensuring appropriate standards of administration;
- ensure that where administration is provided in-house there are appropriate performance levels and internal controls in place; and
- ensure accurate, timely and relevant communications between parties – including members – to support good record keeping and timely reconciliation.

We strongly support the idea that all pension schemes should have an effective SLA in place that includes the right elements and which is regularly maintained and reviewed. The FSA also recommended, in their report on FSA Regulatory Risks and Priorities for 2005, that '*robust contracts and service level agreements*' are required to mitigate the impact of operational failures.

When we will intervene

Intervention will be proportionate to the probability and impact of risk involved, following our risk-based principles. We will intervene in line with our statutory objectives and where appropriate:

- through face to face communication with relevant parties, correspondence, provision of further guidance and support, and (where administrative breaches are brought to our attention which result in a breach of pensions legislation) we can issue third party or improvement notices;
- by considering whether a trustee should remain in position where they have not ensured a good standard of administration within the pension scheme and have failed to improve it;
- by publicly reporting ('naming and shaming') where appropriate those parties, for example TPAs or payroll providers, that consistently provide examples of poor administrative practices and where there is a failure to rectify reported administrative breaches – or where serious administrative breaches are brought to our attention that pose a high risk to members' benefits, for example, where a number of schemes are working with the same administrator and systemic errors are occurring across schemes.

Questions

Do you agree that we have correctly identified the key issues that contribute to poor administration practices? If not please provide your views on the issues that you consider key to ensuring good administration practices within DC schemes.

How prevalent do you consider poor administrative practices to be within the DC pension landscape and do you have any examples?

Do you agree that the regulatory response is appropriate to address the risks and result in better administration? If not please provide your views and / or alternative suggestions.

Do you agree with the regulatory interventional approach suggested for TPAs and / or payroll providers? If not, please provide your views and other suggestions for tackling the issue of poor administrative practices and regulation of TPAs.

Have you identified any other specific risks or issues relating to scheme administration that you think appropriate for the regulator to address?

Chapter 3 – Addressing the risks: poor investment practices

Summary

Objective: that decisions made on the selection and review of investment managers and investment funds are robust so that members' benefits are protected; and that members have sufficient information to make informed decisions relating to their pension fund.

We will provide support by:

- including in good practice guidance:
 - processes to aid selection and regular review of performance of investment manager(s) and fund(s);
 - examples of different approaches to the design of default funds and a list of issues to be considered;
 - examples of investment options, including diversification; and
 - examples of clear and simple information that parties can provide to members.

We expect that (for both trust-based and contract-based schemes):

- rigorous processes are put in place for selection and regular review of investment manager(s) and fund(s);
- an appropriate fund, or range of funds, is provided, ie one that is suited to the existing and anticipated scheme membership; and
- steps are taken to help ensure that members are suitably equipped to make appropriate investment decisions.

We will intervene by:

- reviewing the appointment of trustees where there is a failure to ensure proper review processes are put in place; and
- reporting advisers and providers where there is a consistent failure to carry out a proper review of investment issues, for example, to other regulators, professional bodies and institutes where appropriate.

Introduction

Key risks to members' benefits can arise through the uncertainty of investment performance and the general strength of the financial markets which, if performing badly, can have a significant impact on a member's pension fund. With DB schemes, trustees will decide on the appropriate investment funds, taking into account the scheme's Statement of Investment Principles and Statement of Funding Principles, with the employer taking the investment risk. With DC schemes individuals bear a direct responsibility for their own investment and longevity risk and are required to make decisions on such issues.

The challenge here for the regulator in protecting members' benefits is to ensure that trustees, employers, providers, advisers and members understand the risks associated with investment, for example, for the trustees and providers to ensure that the choice of funds under the scheme is suited to the target audience.

Clearly, a poorly performing investment portfolio could have a significant impact on members' benefits. It is crucial, therefore, that parties who provide and run DC schemes have the right investment manager in place along with robust processes and controls to ensure that regular reviews of the investment manager, fund design and fund performance are carried out periodically in order to determine whether they are still appropriate for their membership.

In trust-based schemes, trustees have a fiduciary responsibility to act in their members' interests and should monitor investment managers and funds as a function of this duty. To do this they need to understand the impact that poor investment strategies and decisions have on members. Our governance survey shows that around 25 per cent of DC schemes surveyed do not hold periodical reviews of the investment funds offered to their members, nor their performance (see figure j below).

Figure j: Formal review at least every three years: differences by scheme size

Review Topic	All trust-based DC and segregated schemes			
	All schemes	12-99 members	100-999 members	1,000+ members
Appropriateness of investment choices offered to members	75%	61%	89%	90%
Performance of investment funds offered to members	76%	65%	88%	91%

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

In contrast, providers of contract-based schemes do not have the same fiduciary responsibility to policy holders. Therefore, employers and their advisers have an important role to play in monitoring the investment options and returns of the scheme's provider.

Key issues which contribute to poor investment practices

The key issues we have identified that could contribute to poor investment practices are:

- inadequate processes for the selection and ongoing review of performance of investment manager(s) and funds;
- provision of an inappropriate fund / range of funds;
- inappropriate design of default fund; and
- lack of member understanding.

Inadequate processes for the selection and ongoing review of performance of investment manager(s) and funds

The performance of investments and the adequacy of the strategic asset allocation are critical to the eventual retirement income of the member. Initial decisions, by those who are running a pension scheme, on the selection of the scheme's investment manager(s) are crucial to ensure that the right person is in place to advise on and manage those funds. If the wrong investment managers are selected, this could have an enormous impact on individuals' funds.

To enable effective monitoring of the performance manager or adviser, as well as the performance of the investment fund(s), there needs to be some transparency in the way they are communicated to those running schemes and members. The selection of funds should ensure that there are avenues to take in the event that a large-scale economic downturn occurs – which further highlights the importance of the selection and regular review process of both the performance of the investment manager(s) and the funds invested in.

Our governance survey shows that the presence of an investment manager or investment consultant as an adviser to the scheme is associated with having processes in place to formally review investment issues, therefore mitigating the risk that investments will not perform as expected. For example, where an investment manager or adviser is in place, the number of schemes that carry out a regular review of investment issues increases by a significant percentage.

Figure k below shows the association of regular reviews with the presence of an investment manager or adviser.

Figure k: Formal review at least every three years – differences associated with presence of investment consultant and investment manager

	All trust-based DC and segregated schemes			
Review Topic	Have investment consultant	Have no investment consultant	Have investment manager	Have no investment manager
Appropriateness of investment choices offered to members	84%	66%	87%	61%
Performance of investment funds offered to members	84%	69%	87%	64%

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

Provision of an inappropriate fund / range of funds

Lack of an appropriate single fund or range of funds can result in some members making choices which do not suit their individual needs and risk appetite.

However, providing a range of funds also means that the arrangements are more complex and could increase the risk of errors and inaccuracies in relation to administration, and this reinforces the importance of good administration practices and the need to put service levels in place at the outset.

The trend in recent years for more schemes to offer ‘lifestyling’ – the automatic move into low risk funds as retirement approaches – involves a trade-off between risk and return for the member. It is important that the lifestyling option is well designed and well implemented so the member’s retirement income is not at risk.

Equally, a lack of regular review by members of the progress of their investment fund(s), or the inadequate provision by trustees or providers of a range of funds, could result in members’ retirement income expectations not being met.

Inappropriate design of default fund

Evidence suggests (as outlined below) that where a default fund is offered, it is likely that the majority of members will choose it as an easy option without fully considering whether it is the best choice for them and that, if such a fund is on offer by trustees or providers, then it must be good value and may be considered by members as ‘implicit advice’.

Members' lack of confidence in making major financial decisions is reflected by the results of the launch of the national DC scheme in Sweden, where 92 per cent of members chose the default fund, from a very large number of options. When questioned many of the Swedish members admitted that they were not sure how to make financial decisions, so they chose the default fund as a 'safe' option.⁵ This highlights the importance both of considering how much choice should be given to members and of the right default fund offered.

This attitude also prevails in Britain, with a recent NAPF survey showing that:

*'Only 15 per cent of consumers feel confident enough to choose how their pension savings are invested. Four out of five people either want the scheme to manage investments for them, or want personal financial advice.'*⁶

Lack of member understanding

While DC provision enables choice, opportunity and control of investment for members, the potential value of these aspects may not be maximised if individuals do not have a full understanding of the issues involved. There is a risk of members' pension funds not increasing in the way expected to allow them to buy the level of retirement income they want if they have made poor investment decisions throughout the life of the pension – particularly when considering the level of risk they want to take.

Expected outcomes and how to achieve them

The outcomes we want to achieve in relation to investment practice are:

- rigorous processes to be put in place for selection of investment manager(s) and for the review of investment manager(s) and fund performance;
- an appropriate fund or range of funds to be provided;
- members to be able to make appropriate investment decisions.

We propose to achieve these outcomes through a combination of existing and new initiatives.

⁵ Choi *et al* 2004; Cronqvist & Thaler; Hewitt Bacon and Woodrow.

⁶ NAPF press release, 'Consumers enter pension debate', 23 February 2006.

Existing initiatives

Current initiatives include:

- our e-learning module on DC risks; and
- the current statutory requirements for a statement of investment principles.

The way forward

How we will provide support

Education and guidance

We will:

- include in the good practice guidance:
 - examples of effective processes to aid selection of investment manager(s) and ongoing review of performance;
 - examples of effective processes to aid review of investment fund performance;
 - how to offer a well designed single fund or a range of well managed funds to suit member demographics;
 - examples of different approaches to the design of default funds and a list of issues for trustees and providers to consider – including the pros and cons of the different options so that those providing the scheme can consider which route they would like to adopt;
 - examples of investment options, including diversification; and
 - examples of clear and simple information that can be provided to members, including investment options, investment performance, decisions to make, level of risk, and a list of questions that should be expected from members.
- expand the member section of our website to ensure generic information on investments is available for members including:
 - an explanation of the risk / reward trade off; and
 - a list of questions to ask advisers, trustees, and providers to help make informed decisions.

Partnership working

The regulator will:

- work in partnership with other bodies (for example government, other regulatory bodies, industry, trustees, providers, employers and advisers) to consider ways to spread information to members about investment options and risks – through partnership forums / working groups, or through focus groups for specific issues.

What we expect

The regulator expects trustees, and where appropriate managers, providers and employers to ensure that:

- there is a robust selection process for investment manager(s) and fund(s) and regular performance reviews;
- a suitable fund or range of well managed funds is offered, especially in respect of the default fund; and
- steps are taken to help raise members' understanding of investment decisions, level of risk and potential impact on benefits.

When we will intervene

- Where there is a failure to ensure proper review processes are put in place which result in poor choice of, for example, fund, as well as poor performance of investment manager, adviser or fund, we will review the position of the trustees.
- Where there is a persistent or significant failure to carry out a proper review of investment issues that have a material impact on members' benefits, we will report advisers and providers to other regulators, professional bodies and institutes, where appropriate.

Questions

Do you agree that we have correctly identified the key issues? If not please provide your views and clarify the issues you consider key.

In your experience, do you agree that poor investment practices exist on a large scale within the industry? Please provide your views and any examples.

Do you agree that the proposed activities will result in the regulator's expectations being achieved?

Do you think that the proposed regulatory response is appropriate? If not, please provide your views and any other suggestions.

Chapter 4 – Addressing the risks: unduly high charges

Summary

Objective: that charges which impact on members' benefits are proportionate, provide value for money and are transparent in a way that supports good decision making by trustees, employers, providers and, where appropriate, members.

We will provide support by:

- including in good practice guidance:
 - examples of how charges can represent value for money
 - examples of typical charges for different types and sizes of scheme that can be used as benchmarks
 - examples of effective review processes to be used to support regular review of charges; and
- working with industry partners to develop good practice guidance and examples of costing benchmarks, and identifying other initiatives where value for money can be achieved in running DC schemes.

We expect that:

- trustees, managers, providers and employers will consider charges at scheme setup and at regular periods to ensure they continue to provide value for money; and
- providers, trustees, and managers will issue information on costs, so that they are clear and simple and show the impact on the pension scheme and, where appropriate, a member's return.

We will intervene by:

- considering the appointment of trustees when reports are received that charges are not reviewed or proportionate so as to have a material impact on members' benefits; and
- reporting to other regulators, professional bodies or institutes, where appropriate, those advisers and providers who consistently apply disproportionate charges in the provision of advice to a pension scheme that have a material impact on members' benefits or where charges are not sufficiently transparent.

Introduction

Charges represent a key area of concern due to the potential impact they can have on a member's final pension income. Lord Turner has suggested that '30 per cent of pensions can disappear in costs and fees'. This is on the basis that pensions would be 30 per cent higher if fund management charges were at 0.3 per cent rather than the current 1.3 per cent for stakeholder schemes.⁷

There are broadly three types of charge incurred by a pension scheme:

- sales and marketing;
- administration; and
- investment management.

In order to protect members' benefits, charges should be considered as part of the setup of the pension scheme and reviewed periodically.

It is important that those parties involved in running pension schemes (trustees, managers, employers and providers) understand and consider the level of charges that will be incurred and the impact that these will have on members' benefits. However, it is important to note that this does not necessarily mean the aim should always be to choose the cheapest option, but rather that the decisions made provide best value for money and that the charges are proportionate to the benefits received.

For example, our governance survey highlighted that around 25 per cent of those DC schemes surveyed have not reviewed their investment fund charges in the last three years, which adds to the risk that the scheme does not provide value for money, as shown in figure I below.

Figure I: Formal review at least every three years: differences by scheme size

	All trust-based DC and segregated schemes			
Review Topic	All schemes	12-99	100-999	1,000+
Level of fund charges	75%	67%	82%	88%

Base: interviews with trustees representing 251 DC and segregated schemes (unweighted), 4,461 DC and segregated schemes (weighted).

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006.

⁷ Adair Turner's speech, 2nd report of the Pension Commission: Impact on the DC industry, DC conference, 12 December 2005.

There should be a sufficient level of transparency and standardisation in how charges are communicated in order that those running the schemes and, where appropriate, members can make fully informed decisions.

In stakeholder pensions (including contract-based group stakeholder pensions) a cap on charges is applied that covers all aspects of running the pension scheme. There is no such cap on either trust-based or personal pension schemes. Our attention therefore is likely to focus on those schemes where there is not the protection of a charge cap.

Key issues which contribute to the risk of unduly high charges

The key issues we have identified that could contribute to the risk of unduly high charges are:

- lack of careful consideration and review; and
- lack of transparency

Lack of careful consideration and review

Where there are disproportionate charges this will ultimately impact on member returns. Charges to DC schemes include:

- setup charges (includes non-allocation periods where contributions are not made to the pension scheme but used to pay setup charges);
- transfer penalties (a deduction may be made from the fund when money is transferred out before the end of the contract);
- ongoing policy fees, often a flat rate administration fee charged monthly or annually;
- bid / offer spreads;
- annual management charges;
- charges for switching between investment funds;
- charges relating to utilising unsecured pensions or alternatively secured pensions;
- charges relating to ongoing advice / drawdown contracts; and
- market value adjustments on with-profit funds.

Lack of transparency

Trustees, managers and employers must understand the charges that are associated with various investment products and services provided in order to make informed decisions for their pension scheme, their members and employees (for example, on the scheme's investment strategy).

Whilst we are not suggesting that members' decisions should be based on cost alone, charging structures are not always as transparent, relevant or simple as they could be to enable member understanding. This means that their decision making may not be adequately informed.

Members are not always aware that in instances where they need to take financial advice, this could be an additional cost. Again this figure is not always transparent and if not disclosed could be prohibitive or disproportionate in relation to the investment gain that it produces.

The FSA has addressed the issue of transparency in relation to contract-based DC schemes, in the form of a robust disclosure regime for members set out in the FSA handbook. Therefore, in relation to contract-based schemes we will focus on employers as they select the pension provider and will need to be fully aware of the costs and charges involved.

Outcomes and how to achieve them

The outcomes we want to achieve are that:

- charging structures are transparent and support informed decision making by trustees, managers, providers and employers so that schemes can offer value for money; and
- members understand the impact of charges on their returns and take this into account when making decisions.

Existing tools

Initiatives currently in place to help ensure charges are considered and transparent include:

- the regulator's approach to appointing trustees from our Trustee Register involves a tender process where the level of fees is considered in relation to the size of the fund and complexity of the scheme. This ensures that fees are transparent and that we source trustees with suitable expertise at a reasonable cost;
- charges on Stakeholder Pensions are already subject to a cap (1 per cent per year for policies issued up to April 2005, and 1.5 per cent for the first 10 years / 1 per cent per year thereafter for policies since then);
- providers of Stakeholder Pensions are required to complete an Annual Declaration confirming that charges are within the charge cap;
- some providers have introduced simpler explanations of costs and impact on returns;
- the FSA provides costs comparison tables on its website to help employers and trustees; and
- the FSA has a disclosure regime in place requiring providers to issue personalised illustrations and key features documents on contract-based schemes.

The way forward

How we will provide support

We will provide support through:

Education and guidance

- by including in good practice guidance:
 - examples of how charges can represent value for money in running a pension scheme;
 - examples of disclosure of information and good communication products;
 - examples of typical charges for different types and sizes of scheme that can be used as benchmarks, recognising the complexity of comparing different arrangements and the risks of not comparing like with like;
 - examples of effective review processes which could be put in place to ensure that value for money continues to be maintained; and
- by expanding the regulator's website to include links to relevant tools, for example, the FSA's cost comparison tables.

Partnership working

- We will work with other partners, including DWP and industry bodies, to identify and investigate initiatives on how value for money can be best achieved in relation to the charges and costs of running DC schemes.

What we expect

We expect that:

- trustees, managers, providers and employers will consider charges at scheme setup and at regular periods thereafter to ensure the scheme continues to provide value for money; and
- providers, trustees and managers will issue relevant, clear and timely information to members, so that they can be clear on the impact the charges might have on the value of their pension fund and help them make informed choices.

When we will intervene

We will intervene by:

- seeking explanations of charges from those running schemes where we become aware of disproportionate charges being applied to either trust-based or contract-based pension schemes that have an unacceptable impact on members' benefits;
- considering the suspension or replacement of trustees when reports are received that charges are not being reviewed or are sufficiently disproportionate to have a material impact on members' benefits; and
- reporting to the relevant professional bodies or institutes, where appropriate, those advisers and providers who apply disproportionate charges in the provision of advice to a pension scheme that has a material impact on members' benefits.

Questions

Do you agree that the main issues are the right ones for the regulator to pursue in the aim of reducing the risk of unduly high charges?

Do you agree that the good practice topics as outlined above are the right ones to help mitigate the risk of unduly high charges? Are there any others that you consider appropriate to include?

Do you agree with the focus of attention and consider the appropriateness of regulatory response adequate? If so, is it your view that the regulator should carry out this role in addressing the issues of value for money and transparency? If not, please provide alternative suggestions if possible.

Chapter 5 – Addressing the risks: poor decisions on retirement choices

Summary

Objective: to ensure that members have the right information to support them in making informed retirement choices.

We will provide support by:

- providing trustees, providers and employers with good practice guidance that includes:
 - steps to take that can lead to members making informed retirement choices, such as providing information on the open market option and on the different types of annuities available
 - examples of effective communication methods to enable them to engage members and support them in making informed retirement decisions; and
- working with trustees and providers to consider ways to influence behaviour on raising member awareness.

We expect that trustees will ensure that members:

- are made aware that they can exercise the open market option;
- are aware of the design of annuities and the different types available; and
- understand the alternative retirement options open to them.

We will intervene by:

- issuing third party or improvement notices where failure to provide information, for example on annuity options, results in a breach of pension legislation; and
- considering the appointment of trustees where we have become aware that they have persistently or significantly failed to provide relevant information to members prior to retirement age.

Introduction

It is vital that members understand that, as well as bearing the investment risks of their DC pension throughout its lifetime, they also bear the risk of selecting the most appropriate post-retirement product for their personal circumstances. Members need to understand, and trustees and providers should make clear, the options that are available.

Because of the lack of understanding or confidence in making decisions, members of DC schemes are usually serial defaulters: they pay the default contribution level to the default fund and take the in-house annuity offered – although we do not presume the member will always lose out if the default option is chosen, as it could be an appropriate option. However, what this highlights is the importance of a well designed pension scheme so that the default options are likely to lead to the desired outcome for most members.

For members who make a conscious decision on their options, it is important that they understand all those available to them. It should also be made clear to members that the decision at retirement is a crucial decision point where the choice could make a significant difference to the amount they receive in retirement income. Because the decision is generally not reversible it is even more significant.

Decisions have to be made on whether and when to purchase an annuity. For example, should an annuity be purchased at retirement, to provide an immediate income, or should the fund be invested in an attempt to increase it or to wait for potentially better annuity rates? This decision will depend upon a number of factors such as the individual's personal circumstances and whether their pension will form their primary source of income.

It is important that members understand the different annuity options that could be open to them at retirement, including:

- level annuities or index-linked annuities;
- single or joint annuity; and
- enhanced or impaired life annuities.

If members are not aware of, or do not understand, these options, then they may not choose the most appropriate product to provide their desired retirement income. All pension schemes are required to ensure members are made aware that they can shop around for the best deal in annuities. It is important that members understand that some annuities may provide better value for money than others.

We want to ensure that the right information is getting to members through the most appropriate route in order that they can make properly informed decisions, thereby protecting their benefits as far as possible.

Key issues which contribute to poor decisions on retirement choices

The key issues we have identified that could contribute to members making poor decisions on retirement choices are:

- lack of member understanding; and
- inertia.

Lack of member understanding

Lack of understanding on the part of the member can result in the choice of an annuity which is not suitable for their individual circumstances.

Recent research carried out by the FSA on open market options of contract-based pension schemes showed that around 55 per cent of members had at least a basic knowledge of annuities.

Although these statistics do show some levels of consumer understanding, we consider that they should be improved significantly in order to provide comfort that members are making the best decisions to suit their individual circumstances.

There are alternatives to purchasing annuities that are available to DC members such as taking a lump sum or income drawdown (unsecured income or alternatively secured income). The regulator takes no view on the appropriateness of the different options available; we want to ensure that members have access to the information that will allow them to make an informed choice according to their needs.

Inertia: open market option

The complexity of the annuity decision, the lack of member understanding and the resulting inertia mean that a great many people currently purchase an annuity from the range sold by the same provider that handled their pension fund. Members who do this can potentially miss out on better returns that are available elsewhere and may not be getting the best value for money.

An example recently quoted in the annuity tables on the FSA website showed that the difference between the best and worst annuity choices can be stark:

'A joint life non-smoker annuity for £100,000 fund for male aged 65 and female aged 62 with a 5 year guarantee level; 50% spouse's pension. The top quote on 19 September 2006 was £6,288 per annum, and the worst was £5,640 per annum, a difference of more than 10%.'

Expected outcomes and how to achieve them

We are looking for the following outcomes:

- members are aware of the open market option and that it is exercised where appropriate;
- members choose an appropriate type of annuity; and
- members understand the alternative retirement options.

Existing tools

There are numerous sources of information in the public domain aimed at raising member awareness of available retirement options, including:

- mandatory information on options is already a requirement for DC pension schemes;⁸
- the regulator's leaflet (*Your retirement choices – money purchase benefits in occupational pension schemes*) available from our website;
- the FSA's annuity comparison tables, to help find the best rates and to help compare with non-annuity alternatives;
- the FSA's consumer information website, providing information on financial products including pensions;
- the DWP's guide, 'Pensions: the basics'; and
- various pension publications that provide examples of annuity rates, and pension information and personal finance sections of national newspapers.

⁸ Paragraph 7 of schedule 2 of the Occupational Pension Schemes (Disclosure of Information) Regulations 1996 as amended by The Personal and Occupational Pension Schemes (Indexation and Disclosure of Information) (Miscellaneous Amendments) Regulations 2005.

The way forward

How we will provide support

Education and guidance

For members we will:

- expand the member section of our website by signposting to information available from other sources (for example, the FSA's annuity tables); and
- review our member leaflet on retirement options (*Your retirement choices – money purchase benefits in occupational pension schemes*).

For parties involved in running and providing pension schemes, we will:

- include in our good practice guidance:
 - steps to take to support members in making informed retirement choices, including the possibility of obtaining higher annuity rates and the most suitable retirement income product for their circumstances; and
 - examples of effective communication methods and channels in the provision of information to members, particularly around encouraging proactive member engagement.

Partnership working

We will:

- work with trustees and providers to consider ways to influence behaviour and raise awareness among members to ensure they understand the decisions to be made and the choices available.

What we expect

We expect trustees, providers and advisers to ensure that members are made aware:

- that they can exercise the open market option;
- of how annuities work and the different types available; and
- of other alternative retirement options open to them.

When we will intervene

We will intervene by:

- issuing third party or improvement notices where appropriate, for example, if we receive reports that information is not being disclosed to members as required by legislation such as on annuity options;
- considering the appointment of trustees where we have become aware that they have consistently failed to provide relevant information to members near to retirement age; and
- reporting providers / advisers to their professional bodies where appropriate.

Questions

In what way should members be engaged, and by whom, so that they can make well planned and informed decisions? What do you consider the role of the regulator should be?

Do you agree that this is the appropriate regulatory response in addressing the issues and the risk? If not, please provide your views and any alternative suggestions.

Do you consider that there are other important areas that should be addressed to minimise this risk? If so, what are they and whose responsibility do you consider it is to address them?

Chapter 6 – Addressing the risks: lack of member understanding

Summary

Objective: that trustees, managers, employers and providers of DC schemes understand, and raise member understanding of, the types of decisions that members need to make and the impacts they could have on their benefits; providing them with the opportunity to make well-informed decisions.

We will provide support by:

- including in good practice guidance:
 - steps to improve member engagement, for example, interactive communication methods
 - case studies highlighting the importance of providing information on the design of DC schemes, and differences from DB schemes
 - examples of high quality statutory money purchase illustrations
 - examples of key facts illustrations; and
- expanding the regulator's website, to include a list of questions members should consider asking those who are running / providing / advising on their pension scheme to help inform their decisions, as well as links to industry tools such as retirement planning tools and the FSA's consumer information website.

We expect that:

- trustees, providers and employers will provide clear, balanced and timely information to members to help raise understanding of their pension scheme; and
- members are armed with information to make well-informed decisions.

We will intervene by:

- issuing improvement or third party notices, where appropriate, to those running pension schemes where we become aware of breaches in pension legislation relating to the disclosure of information.

Introduction

From an early stage in their working life individuals are expected to navigate their way through the often unfamiliar and technically difficult pensions system, and to take complex financial decisions about saving for their retirement. A number of factors contribute to an individual's attitude to pension saving, not least their own personal circumstances, level of income and their ability to save. They need to be financially literate, and to have a view both about pension planning generally and in particular what the state scheme and social security system might provide, factoring that into their decision making.

Increasingly people are expected to be more financially sophisticated so that they understand not just how the pension system operates but also how issues such as increased longevity impact their particular pension. Good quality, relevant and timely information is therefore vital if individuals are to make the best possible decisions.

A good deal of help is already available. The DWP take an active role in encouraging individuals to take out a pension, and the introduction of Personal Accounts takes this a step further. The FSA, in addition, has a key role in promoting awareness of the financial system more generally. In recent years the Government has underlined its commitment to raising awareness of pensions and encouraging high standards of communications through a variety of initiatives including the DWP's green paper, 'Simplicity, security and choice' and the FSA's financial capability study.

As regulator we work to ensure that pension schemes are well run and, once an individual is a member of a pension scheme, that they are equipped with the necessary information to enable them to make decisions, confident that they fit with their personal circumstances. This is particularly significant in the DC environment because of the risk transference from the employer to the individual. If individuals are to plan effectively for their retirement they must have a deeper and broader understanding of the factors which impact their pension and more interactive engagement with those who run their pension schemes.

Key issues that contribute to lack of member understanding

The key issues we have identified that could contribute to lack of member understanding are:

- lack of relevant, clear and timely information; and
- lack of member engagement.

Lack of relevant, clear and timely information

Unless individuals receive good quality and timely information, they risk making ill-informed decisions about their pension provision which could have long-standing effects. One area where a deeper understanding is critical is investment. Many members will be exposed to making investment decisions – possibly for the first time – where perhaps they need to choose between investment funds, whether to split investments between available funds and what level of contributions to make. These are difficult and far-reaching decisions for some, and have the potential to be detrimental to members' benefits if poor decisions are made.

Another key area is understanding the level of saving required in order to generate a reasonable income in retirement. Our governance survey showed that some crucial messages were not reaching members in trust-based DC schemes, particularly in relation to the level of contribution. Around 70 per cent of trustees of DC schemes surveyed did not feel confident that their members understood how much they needed to save to provide them with the income they required at retirement (see figure m below).

Figure m: Variation in perceived level of awareness and knowledge of members according to trustees' level of confidence in the board's performance on member communications

Trustees stating 'virtually all' or 'most' members are aware	All trust-based DC and segregated schemes		
	Aware of range of funds	Aware different funds have different risk	Aware of required contribution levels
All schemes	53%	61%	27%
Schemes that 'strongly agree' that board ensures a high standard of member communications	63%	70%	38%
Schemes that 'tend to agree' that board ensures a high standard of member communications	47%	55%	25%

Source: the Pensions Regulator / RS Consulting: Occupational Pension Scheme Governance (A report on the 2006 scheme governance survey), September 2006

There remains the risk that some may overestimate the amount of pension income they are likely to receive. Whereas in a DB scheme, as long as the employer remains solvent, the pension promise can more readily be understood, this is in contrast to a DC scheme where there is no such promise. Trustees and, to a lesser extent, employers have a pivotal role to play in educating members so that they understand the true value of their pension, and have the necessary information and opportunity to adjust aspects such as contribution levels.

One area where we know some communication risks arise is when employers close their DB scheme and offer a DC scheme in its place. It is necessary to ensure that members are provided with balanced and relevant information highlighting how DC schemes work, how they differ from DB schemes and what it means for them.

Lack of member engagement

It is crucial that those who provide and run pension schemes play a role in ensuring good communications and better member engagement. Ensuring the right level of contact between parties should also contribute towards ensuring members receive their correct pension entitlement as it should aid accurate record-keeping and reconciliation. This is particularly important for deferred members who often fail to realise the impact of not reporting changes in circumstances, such as change of address, to their provider.

Expected outcomes and how to achieve them

The outcomes we want to achieve are:

- raising members' understanding so that they have the opportunity of making well-informed decisions; and
- improving member engagement.

We propose to achieve these outcomes through a combination of existing tools and new initiatives.

Existing tools

There is currently help through:

- the provision of annual statutory money purchase illustrations to all members of DC schemes;
- initiatives put in place by the DWP, which include:
 - their new guide, 'Pensions: the basics'
 - the Pension Education Fund that supports the development of innovative ways to engage with working people about pensions and retirement planning
- initiatives put in place by the FSA, which include:
 - a dedicated pensions section on their consumer information website that also provides information on how to get independent financial advice
 - decision trees for stakeholder pensions
 - a pensions planning tool, covering personal pensions, developed in conjunction with the ABI
 - guidance to employers on how they may want to promote their pension scheme to employees

- some of the larger occupational DC schemes and a number of providers also offer retirement planning tools;
- some employers provide access to financial advice in the workplace; and
- key facts illustrations are mandatory on contract-based schemes.

The way forward

How we will provide support

Education and guidance

We will:

- include in our good practice guidance:
 - steps to take to improve member engagement, such as using interactive communication methods to raise member understanding;
 - case studies highlighting the importance of providing information on the key differences between DB and DC schemes and examples of the type of information that members should be made aware of;
 - help for employers in understanding how they can promote their pension scheme to employees;
 - examples of communication methods and channels that can be used to highlight the importance of regular communication between members and administrators / payroll providers to ensure effective record keeping;
 - examples of high quality statutory money purchase illustrations to highlight the importance to members of reviewing their pension savings;
 - examples of clear, simple information products and campaigns which have proved successful in improving member engagement;
 - examples of key facts illustrations that are mandatory on contract-based schemes and examples of how occupational DC schemes present information to new joiners;

- expand our website by providing:
 - information for members on issues that need to be addressed, including a list of questions that members should ask providers, advisers, trustees and employers, such as descriptions of funds on offer and what it means for them; and
 - links to other bodies' pension tools as outlined above.

Partnership working

We will work with:

- the DWP and FSA, providing relevant input into their education and guidance material; and
- employers in relation to the provision of information in the workplace.

What we expect

It is important that members' understanding and engagement are raised to enable members to be confident that they can make, and are making, the right decisions for their retirement needs through:

- the timely disclosure of balanced, clear and simple information to members, by trustees, employers, providers and managers – for example, six to twelve months before retirement when members need to start considering what to do with their fund; and
- engagement between relevant parties so that they understand what needs to be communicated, and when, in order to protect members' benefits.

When we will intervene

Where we become aware of breaches in legislation in relation to the disclosure of information we can take action by issuing improvement notices and third party notices where appropriate, as well as providing further guidance and support where necessary.

Questions

Do you agree with our analysis of the key areas to address? If not, please provide your views on other areas that should be considered.

Do you consider that the proposed regulatory response is appropriate to address the risk? If not, please provide your views and any alternative suggestions.

Do you agree that the regulator should continue to focus on routing information to members through those running and providing pension schemes rather than directly? If not, can you provide views on where and how you think the regulator will add value?

Have you experienced situations where lack of member understanding has caused a problem and, if so, what practices did you find effective?

Chapter 7 – The consultation process

The regulator is committed to a wide-ranging consultation process. The consultation period will run from 13 November 2006 to midnight on 2 February 2007. We hope to receive responses from all stakeholders within the pensions arena, including:

- pensions practitioners;
- the financial services industry;
- other UK regulators;
- employers' and employees' representative organisations;
- pensions trade and educational bodies; and
- third party administrators and payroll providers.

We would also welcome comments and views either from individuals or collectively from other organisations. If you are responding on behalf of a representative group or organisation, it would be helpful if you could make this clear in your response.

Sending us your consultation response

To make it easier for you to respond, a pro-forma has been provided which includes a list of the consultation questions. This is available on our website at:

www.thepensionsregulator.gov.uk/pdf/dcRisksResponse.doc

We would like you to use the pro-forma for your response, if at all possible, and to send it to us by email or by post, to the following address:

By email:

dc@thepensionsregulator.gov.uk

By post:

DC Consultation, Policy and Guidance team
The Pensions Regulator
4th Floor, Napier House
Trafalgar Place
Brighton BN1 4DW

Using information

We may need to share the information you send us within our own organisation or with other government bodies. We may also publish this information as part of our consultation response.

Appendix 1 – Interests of regulatory bodies in relation to audiences of trust-based and contract-based schemes

AUDIENCE	TYPE OF ARRANGEMENT	THE PENSIONS REGULATOR	THE FINANCIAL SERVICES AUTHORITY	OTHER
Trustees	Trust-based	Key audience – have legal responsibility for ensuring the protection of members and ensuring that schemes are run in accordance with legal requirements.	Not a usual audience for FSA – although sometimes trustees have a role in businesses regulated by FSA, which leads to necessary liaison between FSA and regulator.	
Providers	Contract-based (includes personal pensions and stakeholder pensions)	Key audience for regulator – interested in relation to work-based arrangements and in particular their administration and design. Proposed involvement of regulator could be in the form of public reporting or the issue of improvement notices where appropriate.	The FSA regulates the sales and marketing of personal (including stakeholder) pensions and annuities, and is responsible for the prudential regulation of the firms who provide personal (including stakeholder) pensions and annuities. From April 2007 the FSA will be responsible for regulating the establishment, running and winding up of personal pension schemes including SIPPs.	
Employers	Trust-based and / or contract-based	Current involvement with regulator in relation to paying member contributions and providing access to stakeholder pensions: taking enforcement action where appropriate. Proposed regulatory involvement includes provision of practical guidance to ensure employers understand the risks to members of DC schemes, and encouragement to engage members.	Not a primary audience. However, they provide information on specific topics to help employers, for example, on how they can promote their pension schemes to employees without breaching FSA rules.	
Third Party Administrators	Trust-based and / or contract-based	Proposed key audience for regulator in relation to our statutory objective of promoting good administration. Regulator can take action where appropriate, for example through the issue of third party notices and public reporting.	Generally outside the scope of FSA regulation. However, some may be conducting regulated activities and where a provider outsources to a TPA the FSA would expect there to be systems and controls in place to ensure consumers are not disadvantaged.	There is not one body directly responsible for regulating TPAs.
Advisers (auditors, investment managers, actuaries etc)	Trust-based and / or contract-based	Key audience for regulator as they have a key role in the type of scheme set up and are often involved in its administration and review. Proposed regulation includes issuing improvement or third party notices and public reporting to professional bodies.	FSA regulates investment managers and IFAs (who may be giving advice to consumers or the trustee).	
Members	Trust-based and / or contract-based	Less direct communication: proposals include targeting this audience through third parties such as trustees and employers whilst supporting other industry activities through signposting and linking from our website.	FSA has a statutory responsibility to promote understanding of the financial system. It has requirements in place aimed at improving the financial capability of members which includes direct communications and has regulatory responsibilities in respect of consumers and members of contract-based schemes.	Primary audience for DWP in relation to the take-up of pensions generally.

Appendix 2 – Comparison of key features of different types of pension arrangement

FEATURES	OCCUPATIONAL MONEY PURCHASE SCHEMES	GROUP PERSONAL PENSIONS	STAKEHOLDER PENSIONS
Who chooses the pension provider?	The employer and scheme trustees make all the arrangements.	Employer	
Does the employer contribute?	Usually – employees do not have to pay income tax on employer contributions.	Possibly – employees do not have to pay income tax on any employer contributions.	
Does the employer deduct employee contributions from salary?	Yes		
Does the employee get tax relief on their contributions?	Yes – the employer deducts employee contributions from salary before it is taxed.	Yes – the employer deducts contributions from take-home pay and sends to pension provider. The pension provider claims tax relief from HMRC at the basic rate (22 per cent) and adds to the fund. Higher rate tax is reclaimed via tax return.	
Are there limits on how much employees can contribute and receive tax relief?	Maximum contributions = earnings up to Maximum Annual Allowance of £215,000 for 2006–07.		
Can employees top up their contributions?	This depends on the rules of the scheme.	This depends on the rules of the scheme – most will allow additional contributions.	
Do employees have to make regular or monthly or weekly contributions?	No, but this is usual.		
Can employees stop their contributions when they want to?	This depends on the rules of the scheme.	Yes – but there may be conditions on restarting them.	
Will employees have to pay any charges?	The employer may pay some of the charges and others are deducted from the pension fund.	Charges may vary between providers. The provider deducts them from the pension fund. The employer may pay some charges.	Management charges are capped. The pension provider deducts them from the employee's pension fund, usually monthly. There are no initial or exit charges.
Do employees get a choice about how contributions are invested?	Usually – the range of choice depends on the scheme.	Yes – the range of choice depends on the pension provider.	
Can employees switch their investments?	Usually – subject to the rules and investment choices of the scheme.	Yes – but there are usually some restrictions and charges.	
Can employees take the pension fund with them when they leave their job?	Employees can transfer their employer-based pension fund to a stakeholder or personal pension, 'buy-out contract', another occupational pension scheme, or leave it where it is.	Yes – they can arrange with the pension provider to carry on contributing (charges may increase).	
Is there now a limit on how much pension people can have?	Funds greater than the Lifetime Allowance (£1.5m, 2006–07) are subject to the Lifetime Allowance charge.		
Can employees choose the company that pays their pension (ie buying an annuity)?	Yes – information on the open market option must be provided to the scheme member.		

Appendix 3 – DC schemes: our current regulatory response in relation to education and guidance

The regulator and its predecessor Opra have had responsibility for regulating DC schemes since April 1997, and we already have a number of regulatory tools that can and do help in mitigating the risks to members of DC schemes.

Our aim has been to provide trustees and managers with an understanding of our expectations in their role of ensuring that pension schemes are well run and that members' benefits are protected. This is particularly important in the context of DC schemes where complex decisions need to be made by members.

We have done this through the following tools:

Trustee knowledge and understanding (TKU)

The Pensions Act 2004 requires trustees to have appropriate knowledge and understanding of the law relating to pensions and trusts, the principles relating to the funding of occupational pension schemes and the investment of the assets of such schemes, and to be conversant with their own scheme's policy documents. Responding to these requirements, the regulator's TKU framework is already well under way.

The TKU framework has been, and is continuing to be, developed on the back of extensive industry participation and consultation. As well as a code of practice we have developed an indicative syllabus, available on our website at:

www.thepensionsregulator.gov.uk/pdf/tkulndicativeSyllabus.pdf

The latter has been passed to the Financial Services Skills Council so that it can be used in the development of educational material and qualifications to promote consistent quality and standards in the delivery of training for trustees.

A number of e-learning modules have been developed, and the module on DC schemes has been published alongside this consultation document.

Codes of practice

Codes of practice are intended to provide practical guidelines on how the requirements of pension legislation may be met, and set out the standards of conduct and practice expected of those who must meet these requirements. They are not statements of the law and there is no penalty for failing to comply with them. Nevertheless, codes have legal effect; they must be taken into account by the Pensions Regulator, a court or tribunal if they are relevant to the case being decided. Some of the codes cover contract-based as well as trust-based schemes.

The following codes of practice are in place and can be used to help mitigate a number of the risks outlined in this document:

- **Reporting breaches of the law** – this mitigates the risk of poor administration, for example, in relation to lack of or poor disclosure of information to members, and relates to both trust-based and contract-based schemes.
- **Reporting late payment of contributions to occupational money purchase schemes** – this relates to ensuring accurate and timely payment of contributions to trust-based schemes. It is directed at trustees of DC work-based schemes which are required to prepare and maintain a payment schedule. It complements the reporting breaches code by giving specific guidelines on reporting late payments.
- **Reporting late payment of contributions to personal pensions** – as above, but this is directed to managers of contract-based schemes. It is also relevant to employers in relation to the provision of payment information needed by managers for monitoring purposes.
- **Member-nominated trustees and directors** – this covers putting arrangements in place for trust-based schemes to ensure that members are involved in running the scheme.
- **Internal controls** – these are an important feature of good governance and can be used to inform actions across all risk areas. Risk assessment is a continuous process and must take account of a changing environment. Internal controls should therefore be reviewed periodically – at least annually, or more frequently if substantial changes occur.