National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 466
SESSION 2012-13

11 JULY 2012

The Pensions Regulator

Regulating defined contribution pension schemes

Our vision is to help the nation spend wisely.

We apply the unique perspective of public audit to help Parliament and government drive lasting improvement in public services.

The National Audit Office scrutinises public spending for Parliament and is independent of government. The Comptroller and Auditor General (C&AG), Amyas Morse, is an Officer of the House of Commons and leads the NAO, which employs some 860 staff. The C&AG certifies the accounts of all government departments and many other public sector bodies. He has statutory authority to examine and report to Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively, and with economy. Our studies evaluate the value for money of public spending, nationally and locally. Our recommendations and reports on good practice help government improve public services, and our work led to audited savings of more than £1 billion in 2011.

National Audit Office

The Pensions Regulator

Regulating defined contribution pension schemes

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 9 July 2012

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

Amyas Morse
Comptroller and Auditor General
National Audit Office

6 July 2012

HC 466 London: The Stationery Office £16.00

This report examines the effectiveness of the regulation of defined contribution pension schemes, and how well the objective to protect members' benefits is being realised.

Printed in the UK for the Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office

2502010 07/12 PRCS

Contents

The National Audit Office study team consisted of:
Simon Banner, Elena Bechberger, Shannon Burns, Fiona Lee and Ivan O'Brien, under the direction of Alex Scharaschkin

This report can be found on the National Audit Office website at www.nao.org.uk/pension-schemes-2012

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Enquiries: www.nao.org.uk/contactus

Website: www.nao.org.uk

Twitter: @NAOorguk

Key facts

3.4m
approximate number of active members in defined contribution pension schemes, in 2011

5m–8m
new active members forecast to join defined contribution schemes 2012–2018

£8.5bn
estimated tax relief for employer sponsored, private sector defined contribution pension schemes, in 2010-11

£386 billion	estimated total assets in defined contribution pension schemes, in 2010
£6.7 million	estimated spending in 2010-11 by The Pensions Regulator on regulating defined contribution schemes
17 per cent	estimated difference in final pension pot size between schemes with low and high charges
£500 million to £1 billion	independent estimate of potential retirement income loss for people retiring each year resulting from poor annuity decisions
£10 billion to £16 billion	Department estimate of increase in private pension income by 2050 through automatic enrolment

Summary

1 Defined contribution pension schemes are one method of work-based saving for retirement. They provide a retirement income for scheme members, from a pot of money accumulated during their employment. The pot is built up by investing contributions paid in (usually) by the employee and the employer. These contributions are subject to tax relief. On retirement, the pot is most commonly used to buy an annuity (regular payment), which provides an income for the rest of the member's life.

2 In 2010, work-based defined contribution pension schemes held assets worth an estimated £386 billion. Membership of such schemes has increased considerably over the last decade, with approximately 3.4 million active members[1] in the UK in 2011. New legislation, referred to as 'automatic enrolment', will require employers (beginning with the largest) to enrol employees automatically in a pension scheme from October 2012 onwards. The Department for Work and Pensions (the Department) forecasts this to increase the membership of defined contribution pension schemes by between 5 million and 8 million by 2018.

3 Automatic enrolment is part of a larger pension-reform programme by the Government with the aim of meeting the challenges of an ageing society with a simpler state pension, encouraging more private savings and encouraging people to work longer. The Department stresses that, compared to the millions who are currently not contributing, members of work-based defined contribution schemes achieve a better retirement pension as they typically benefit from an employers' contribution in addition to their own.

4 Members of defined contribution schemes are on average more likely to achieve considerably lower levels of retirement income than those with predominantly defined benefit savings, where the members' retirement income is defined. This difference typically reflects lower rates of contributions by both the member and the employer, and that contributions may be made over a shorter period. Direct comparisons are difficult, but combined contributions from employers and employees in open, defined contribution trust-based schemes are on average 9 per cent of an employee's salary, compared to 20.5 per cent in defined benefit schemes.

1 An active member is someone building up pension benefits from their current employment.

5 In defined contribution schemes, employees bear the risk of insufficient pension contributions to fund their retirement, for example because of short contribution periods, or increased life expectancy. However, employees' ability to manage this risk is constrained by generally poor levels of financial understanding, and the complexity of pensions. Sometimes key decisions, such as the employer's choice of scheme, are made for employees without their involvement. There are two government agencies responsible for the regulation of defined contribution pension schemes. The Pensions Regulator, an arm's-length body established in 2005, is responsible, through its statutory objectives, for protecting the benefits of members of defined contribution schemes. It regulates all work-based pension schemes, although it shares responsibility for regulating some defined contribution schemes – personal work-based (also called contract-based) schemes – with the Financial Services Authority. The Department, HM Treasury and HM Revenue & Customs all have responsibility for setting the overall policy framework for pensions.

6 Many factors affect outcomes for pension scheme members and there can be considerable variation in the returns that members achieve from their pension savings. Much of this variation is attributable to factors that are outside the scope of the regulatory system for pensions. Examples of such factors are the level and duration of contributions; investment performance (which depends on the wider performance of the economy); government decisions on minimum contribution levels; tax relief for pension contributions; and Bank of England decisions about interest rates and quantitative easing (which could influence annuity levels). However, other factors which affect outcomes can potentially be addressed by regulation, for example the extent to which members receive transparent and accessible information to make informed choices, and the quality of scheme administration. Effective regulation should aim to clearly define the factors it seeks to influence, specify what is an 'acceptable' degree of variation in factors which it seeks to influence, and act to address the risks of unwarranted variation outside of this 'acceptable' level.

7 This report examines the effectiveness of the regulation of defined contribution pensions, and how well the objective to protect members' benefits is being realised. Our criteria for good value for money were that:

- The Pensions Regulator has sufficient skills and market information to adopt a risk-based approach to deploy its resources;
- The Pensions Regulator has an effective framework to measure its performance in relation to meeting its statutory objectives;
- the wider regulatory system within which The Pensions Regulator operates is well-integrated, with a common risk framework supported by a strong evidence base, clear accountabilities and responsibilities, and clear ways to intervene to address risks through regulatory action if necessary; and
- there should not be unwarranted variation in outcomes, or in the factors that contribute to those outcomes, for scheme members, given broadly similar contribution levels and investment performance. There should be evidence that regulation is helping to address any unwarranted variation.

Key findings

8 **The taxpayer has a substantial interest in the regulatory system being effective.** In 2010-11, tax relief for employer sponsored, private sector defined contribution schemes amounted to an estimated £8.5 billion.[2] The Department estimates that introducing automatic enrolment will increase private pension incomes by between £10 billion and £16 billion by 2050 and that this will save £1 billion in income related benefits by 2050.[3] These figures imply a significant growth in defined contribution pensions, with new savings products entering the market, and that scheme members will achieve good outcomes from their pension savings.

The Pensions Regulator's resources and evidence base

9 **The Pensions Regulator is increasing the proportion of its resources devoted to regulating defined contribution schemes.** Active membership of defined contribution schemes overtook membership of defined benefit schemes in 2005. The Pensions Regulator estimates that defined contribution regulation accounted for 22 per cent of its activities in 2011-12, which is around £6.7 million, and expects to devote more resources to defined contribution schemes as the market grows with automatic enrolment, from October 2012. The Pensions Regulator has considerable skills and experience in regulating trust-based schemes. However, the market is changing and a majority of defined contribution scheme members now belong to contract-based schemes, so a different regulatory approach may be needed. The Pensions Regulator has now developed a plan – the Defined Contribution Programme – to deal with these changes. The Pensions Regulator's approach to resourcing is to flexibly match skills to operational activity including use of secondees, and, in February 2012, it began an internal analysis of the skills it needs in this area. It has not, however, commissioned an independent review of its capability since it was established.

10 **The Pensions Regulator adopts a sound approach of aiming to regulate in a targeted, proportionate and risk-based way, although the nature of the market makes this difficult to implement effectively.** The Pensions Regulator has undertaken a comprehensive review of risks to members and used this to develop its targeted regulatory approach. It seeks to only use enforcement action where education is not effective and has published wide-ranging guidance to employers, trustees and intermediaries. Its regulatory audience consists of many employers and trustees, and it has more difficulty in reaching less engaged employers and trustees where the risks to individual member outcomes are likely to be greatest.

11 **The Pensions Regulator's evidence base is improving.** The Pensions Regulator has improved its knowledge of schemes and is working with the industry to establish a shared understanding of the most important technical issues where regulatory intervention might be effective.

2 Estimates provided by HM Revenue & Customs and the Office for National Statistics.
3 All monetary amounts are shown in 2011-12 prices unless otherwise stated.

Measuring performance against regulatory objectives

12 The Pensions Regulator's performance measurement system has limitations. The Pensions Regulator's performance measurement system has positive elements and has been effective in measuring the impact of some of its regulatory activities. The Pensions Regulator sets performance targets and met 6 out of 11 targets in the three years to 2010-11. But the indicators relate mainly to trust-based schemes; they tend to measure processes or actions undertaken, rather than outcomes from regulatory action; and change as regulatory activities change, meaning they do not always provide a stable basis for measurement over time, making it difficult to assess progress.

13 One of the problems in measuring performance is that it is not fully clear how The Pensions Regulator's objective to protect member benefits relates to its roles and responsibilities, where regulatory responsibilities are shared. The Pensions Regulator has the statutory objective to protect the benefits of members of work-based defined contribution schemes. It has now set out the principles and features of defined contribution schemes that should support the delivery of good member outcomes, but these have not yet been translated into intermediate objectives focused on actual member outcomes which are more specific and capable of measurement. It shares regulatory responsibility for contract-based schemes with the Financial Services Authority which has its own objectives, but there are no overarching objectives against which overall regulatory action on pensions can be assessed.

The Pensions Regulator within the wider regulatory system

14 There is no single public body leading on the regulation of defined contribution schemes and ultimately accountable for the delivery of regulatory objectives. The Department oversees the work of The Pensions Regulator, and the Treasury is responsible for setting the overall legislative framework within which the Financial Services Authority operates. All four public bodies participate in a senior level group which discusses defined contribution scheme issues. But none of these bodies leads on, or is accountable for, the regulatory system as whole, for example, setting clear system objectives and monitoring performance against them. There is also no overarching system for measuring the performance of both The Pensions Regulator and the Financial Services Authority in reducing risks to members, and the senior level group has not established a joint risk register.

15 The shared regulatory responsibilities require The Pensions Regulator to work together with the Financial Services Authority, but there are no overarching objectives and no common framework across the regulatory system for making evidence-based assessments of risks to members. The Pensions Regulator has undertaken work to identify and assess the risks to defined contribution scheme members. But without a more integrated framework, it is difficult to assess whether there are any gaps within the existing regulatory arrangements which should be addressed, for example with regard to advice to businesses, which is currently unregulated. Neither The Pensions Regulator nor the Financial Services Authority collects data on the investment returns (after fees and charges) of defined contribution pension schemes, and how those returns (adjusted for different risk profiles and contribution levels of the membership) vary across the different segments of the market.

16 Because there is insufficient clarity regarding regulatory objectives and risk assessment, it is unclear whether The Pensions Regulator has an appropriate level and range of powers. The Pensions Regulator has statutory powers to promote good practice and to take more formal actions, such as fining employers who do not maintain contributions. These powers provide a range of options for regulating trust-based schemes, which include the power to remove and replace trustees. But in contract-based schemes, where responsibilities are shared with the Financial Services Authority, The Pensions Regulator has fewer options to intervene directly compared to trust-based schemes. It has no powers regarding the providers of contract-based schemes, but it has the statutory objective to protect members' benefits in these schemes.

Regulatory outcomes

17 Outcomes for defined contribution scheme members can vary considerably, even if factors outside the control of regulation are held constant, such as investment performance and contribution levels. Choices made by, or for, members can substantially impact on obtaining good outcomes. The size of final pension pots for members in high- or low-charging schemes, contributing the same amount, and experiencing the same stock market performance, can vary by an estimated 17 per cent, but around a third of members, and a fifth of schemes, stated that they cannot assess whether the charges they pay represent value for money. Research suggests that differences in annuity rates can reduce the value of a pension by up to 22 per cent, so it is vital that members make an informed decision, but around 30 per cent of trust-based scheme members do not recall being made aware of the option to choose a different annuity provider.

18 Effective governance arrangements can help protect members, but they can vary considerably across different schemes. In contract-based schemes the individual employee holds a contract directly with the scheme provider, whose conduct is regulated by the Financial Services Authority, but there is no equivalent representation to that of trust-based schemes where trustees have a statutory responsibility to act in the interest of all members. Additionally, the engagement and quality of trustees representing members vary across trust-based schemes. While members and their representatives can take some steps to protect themselves, it is not fully clear to what extent they should be expected to do this, and how far regulation should intervene on their behalf.

19 **The impact of regulation in reducing unwarranted variation in outcomes for pension scheme members is unclear.** It is challenging for any regulator to measure the outcomes that it seeks to achieve, partly because of the difficulty in measuring what would happen in the absence of regulatory action. The Pensions Regulator reports improvements in its objective to improve administration of schemes, through better record-keeping and faster scheme wind-ups. It is, however, difficult to define or assess progress in meeting its statutory objective to protect the benefits of defined contribution scheme members. This is because the objective is not clearly measurable, sharing of responsibilities for contract-based schemes with the Financial Services Authority makes it difficult to separately identify their respective influence, and there are no indicators to measure their overall influence. In June 2012, The Pensions Regulator set out detailed expectations of good service for members of both trust and contract-based defined contribution schemes. Its success in protecting the interests of members will be dependent on it being able to obtain transparent and comparable information from scheme providers and administrators, and there being clarity within the system about where the responsibility for action lies, if the evidence suggests regulatory intervention is necessary.

Conclusion on value for money

20 The Pensions Regulator has assessed risks to members and its overall risk-based approach is sound. With regard to its statutory objective to promote, and improve understanding of, the good administration of schemes, it can point to some improvements and it has begun to implement actions to address some shortfalls. We consider that it has achieved value for money in those areas. Measuring regulatory impact is challenging. But The Pensions Regulator's current system of performance measurement does not yet include sufficient indicators for it to be possible to judge whether it is achieving value for money with regard to its wider strategic objective of protecting member benefits.

21 The system for regulating defined contribution pension schemes as a whole lacks clear, overarching objectives for what regulation seeks to achieve. The objective of protecting member benefits rests with The Pensions Regulator, but it is unclear how this aligns with the roles and responsibilities of all bodies across the regulatory system. There is no common framework for assessing risk, collecting evidence and measuring performance across the different bodies involved, and no single body has overarching responsibility for the delivery of regulatory objectives. As a result there is insufficient accountability to ensure that the system delivers value for money for the taxpayer.

Recommendations

22 We address the following recommendations to The Pensions Regulator:

a **The Pensions Regulator should develop new approaches to specifically address those segments of the market it finds more difficult to reach.** The nature of the defined contribution pensions market makes it difficult to reach less-engaged employers and trustees and to educate and enable them in a cost-effective way. The Pensions Regulator should think creatively about how best to improve outcomes for scheme members in those market segments and should consult with industry and other stakeholders about potential solutions.

b **The Pensions Regulator should in due course conduct an independent, comprehensive review of capabilities to examine what skills it may need to meet its objectives.** This review should follow the establishment of overarching objectives for the regulation of defined contribution pension schemes by the Department for Work and Pensions and HM Treasury, in light of recommendation 23 (a) of this report. Following the review it should set out the specific steps it will take to acquire any additional skills.

c **The Pensions Regulator should strengthen its framework for measuring performance.** The Pensions Regulator should develop a stronger framework for measuring performance and outcomes in defined contribution pensions by:

- using performance measures of regulatory activities which focus as directly as possible on outcomes rather than intermediate measures, and increasing the number of performance measures which do not change from one year to the next so as to enable greater analysis of long-term trends; and
- introducing a set of overarching indicators that broadly cover the factors affecting member outcomes in defined contribution pensions, including indicators for both trust-based and contract-based schemes.

23 The overall regulatory regime for financial services, of which pensions form a part, is currently being significantly reconfigured, and the Department is also introducing major reforms in pensions policy. It is important that agencies work together effectively during this period of change, to ensure that risks to members of defined contribution schemes are appropriately assessed and acted upon if necessary. We therefore also make the following wider recommendations regarding the regulatory system:

a **The Department and the Treasury should work with The Pensions Regulator and the Financial Services Authority to establish overarching objectives for the regulation of defined contribution pensions.** As the number of oversight bodies in the system will further increase with the future split of the Financial Services Authority into the Financial Conduct Authority and the Prudential Regulation Authority, it is of particular importance that it is sufficiently clear what the regulation of defined contribution pensions is seeking to achieve in this market. The Department and The Pensions Regulator should also establish more specific, measurable objectives for the latter, linking directly to overarching objectives.

b **The Department and the Treasury should work with The Pensions Regulator and the Financial Services Authority to develop a more integrated, evidence-based framework for assessing risks to member outcomes.** They should use this framework, and the objectives they develop, to clarify responsibilities between the regulators, to establish whether there are any potential gaps or overlaps in regulatory coverage, and to consider whether the regulators need any additional powers. They should also clarify who is accountable for the delivery of regulatory outcomes.

c **The Pensions Regulator, the Department, the Treasury and the Financial Services Authority should develop an integrated framework for measuring performance against objectives across the whole regulatory system.** Across all markets, it is difficult to measure the outcomes that regulation seeks to achieve, partly because of the difficulty in measuring what would happen in the absence of regulation. But performance measurement is essential to understanding whether objectives are being met, and whether regulatory resources are being directed to where they are needed most. Once it is clearer what the regulatory system seeks to achieve, The Pensions Regulator should work with others to develop indicators to measure progress against these objectives; to analyse where regulatory resources may have most value in contributing to good member outcomes; and to develop and maintain a measure of the potential impact on taxpayers. Implementing an integrated performance measurement framework will require effective exchange of information between each organisation.

Part One

The defined contribution pensions market and its regulation

Moving from defined benefit to defined contribution pension schemes

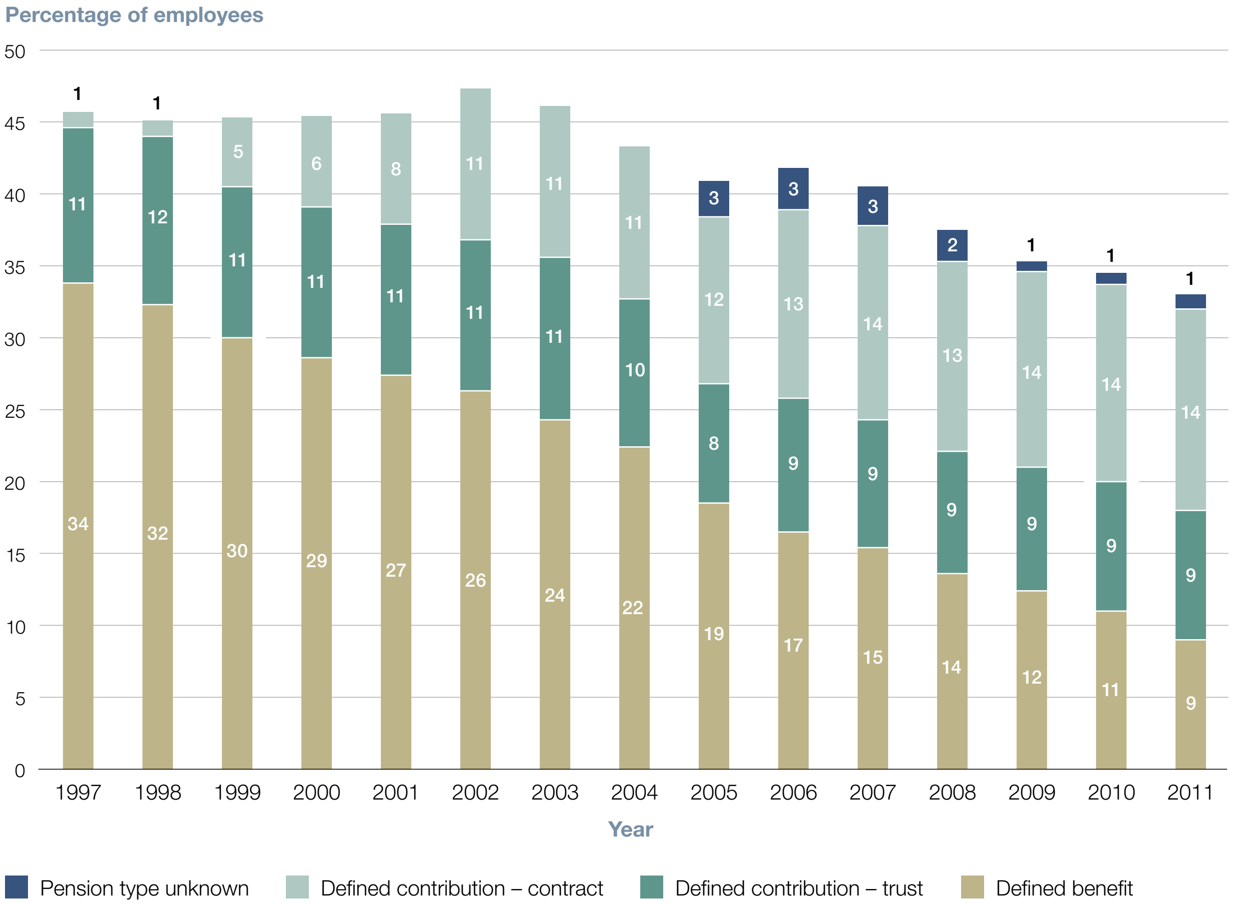
1.1 The nature of workplace pensions has changed considerably over the last 15 years. Members of defined benefit schemes receive benefits through a set formula based on salary levels and duration of contributions. While defined benefit schemes make up a significant share of the private sector pensions market, active memberships are decreasing as a proportion of work-based scheme provision (**Figure 1** overleaf). The last defined benefit scheme in a FTSE100 company will close to new members in 2013. In contrast, the proportion of employees with active membership of defined contribution schemes has almost doubled from 12 per cent to 23 per cent between 1997 and 2011, according to Office for National Statistics estimates.

1.2 In 2010, work-based defined contribution pension schemes held assets worth an estimated £386 billion. There were approximately 3.4 million active members of such schemes in the UK in 2011. No single body collects information on total defined contribution scheme memberships, so we have compiled data and estimates from several sources. The Pensions Regulator's records show one million active trust-based scheme members, while the Office for National Statistics estimates 2.4 million private sector jobs where employees contribute to contract-based schemes. There are also 1.5 million 'inactive' members of trust-based schemes,[4] and there are likely to be several million inactive members of contract-based schemes, although official estimates are not currently collected by any organisation. The trend towards defined contribution schemes is expected to accelerate. It is forecast that introducing automatic enrolment will increase active membership by between 5 million and 8 million people over the period from October 2012 until February 2018.

4 From The Pensions Regulator's records, 2012. Inactive memberships occur where benefits are no longer built up but the member still retains rights in the pension, for example, the member has changed employer.

Figure 1
Membership of private sector defined benefit and defined contribution schemes

The proportion of employees with active membership of defined contribution schemes is increasing



NOTES

1 The remainder of the 100 per cent represents employees with no workplace pension provision.

2 Results from 2005 were based on a new questionnaire and may not be comparable with earlier results.

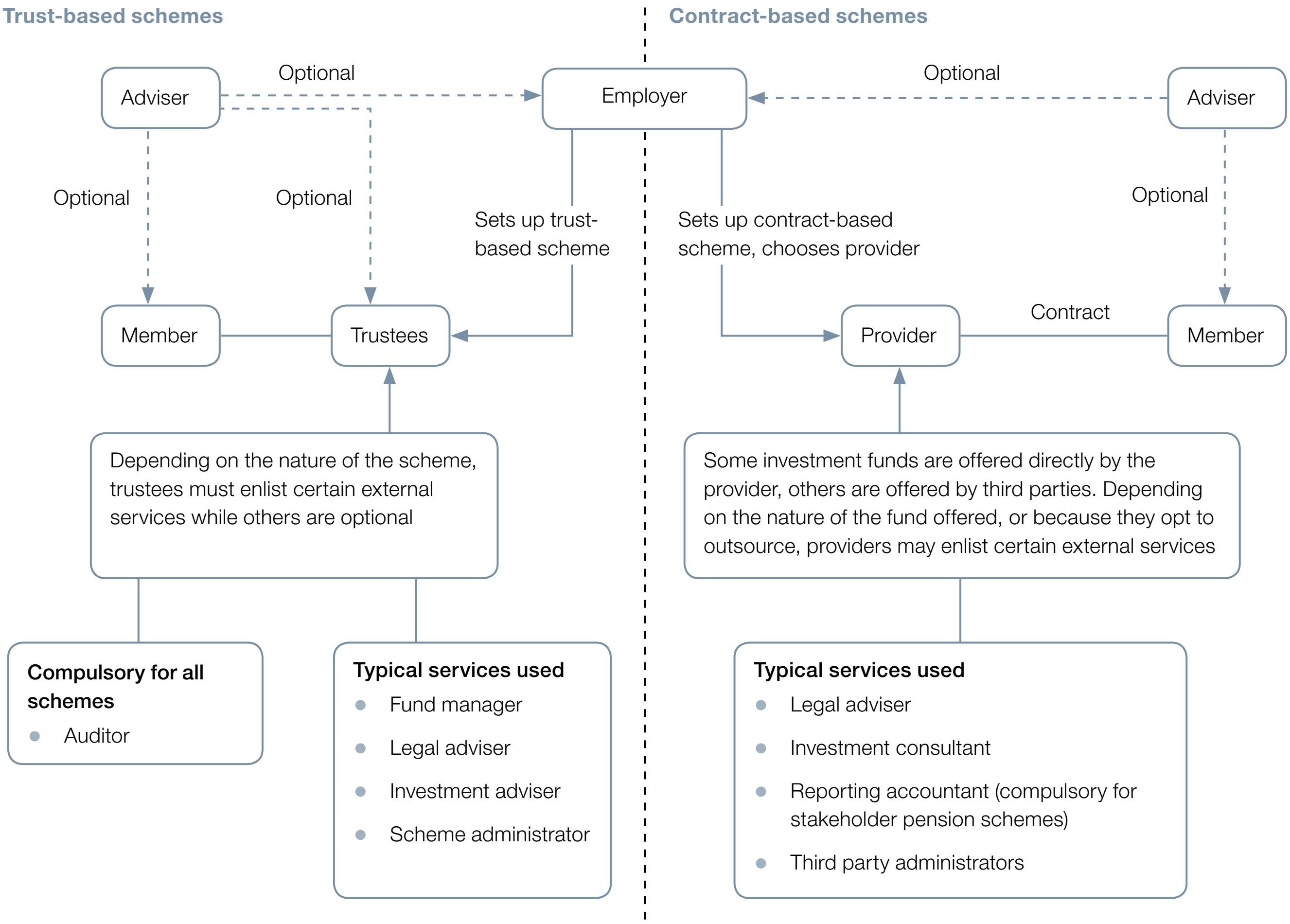
3 Figures do not sum due to rounding.

Source: National Audit Office analysis of Office for National Statistics estimates, Annual Survey of Hours and Earnings data, 2011

1.3 There has also been a shift within the defined contribution segment from trust-based to contract-based schemes. In a trust-based scheme, a trustee board manages the scheme and trustees are legally obliged to act in the best interests of members. In a contract-based scheme, the individual employee holds a contract directly with the insurance company providing the scheme. These insurance companies are authorised and regulated by the Financial Services Authority and must, among others, abide by Conduct of Business and Treating Customers Fairly rules. The employer decides which type of scheme to run and which provider to use.

1.4 The proportion of employees with membership of contract-based schemes increased from 1 per cent in 1997 to 14 per cent in 2011. The relationship between key participants in the two types of scheme is outlined in **Figure 2**. The Department forecasts, with the advent of automatic enrolment, a significant increase in trust memberships with the launch of the National Employment Savings Trust (NEST) scheme and similar schemes.

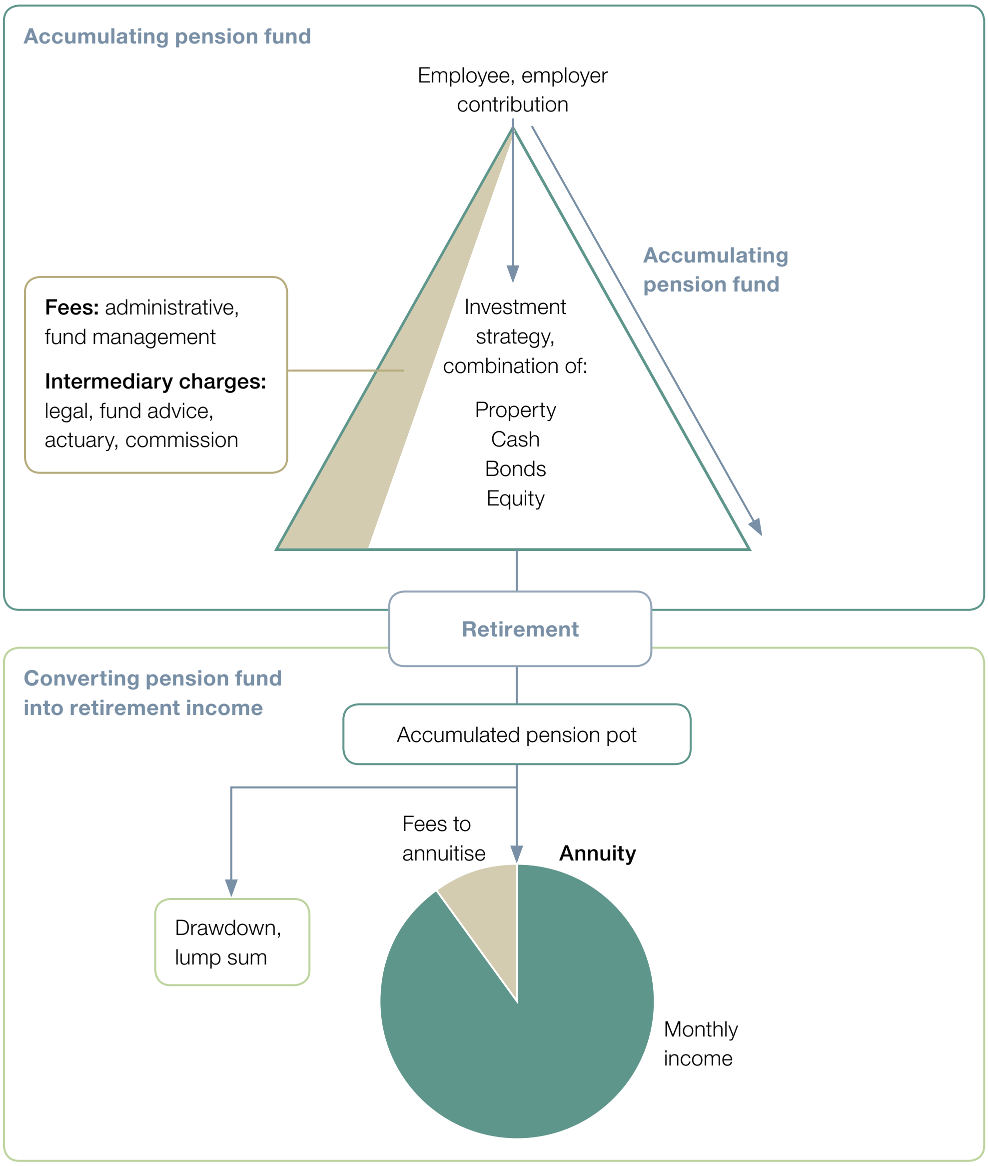
Figure 2
Members within the pensions landscape



Source: National Audit Office analysis

1.5 In both scheme types the employer and the employee usually contribute a fixed rate to the scheme, typically as a percentage of salary, and receive tax relief on contributions.[5] Contributions are invested in a range of stocks, shares and other investments, to grow the fund before retirement (**Figure 3**). Upon retirement a financial product, usually a lifetime annuity, is purchased to provide an income. Members can also draw a limited amount as a lump sum, or as an alternative to purchasing an annuity can draw down monthly amounts from their pension fund while leaving it invested.

Figure 3
Summary of the defined contribution pension life cycle



Source: National Audit Office analysis

5 In 2011-12, up to £50,000 of contributions.

Moving towards defined contribution schemes has risks for individual members and taxpayers

1.6 A key difference between defined benefit and defined contribution pension schemes is how risk is allocated between the employer and member. There are two main types of risk:

- **Investment risk** Poor investment performance may lead to a smaller payout than needed or expected to support the member in retirement.
- **Longevity risk** A scheme member will live longer than expected, requiring the available pension funds to be spread over a longer period in retirement.

In a defined benefit plan the sponsoring employers bear the investment and longevity risk, and they must change contributions as investment returns vary. In a defined contribution scheme employers bear no responsibility for the pension outcome achieved and each member must secure an adequate income on retirement.

1.7 Comparisons between defined contribution and defined benefit contribution levels are difficult to make for various reasons, for example many defined benefits schemes have increased payments following lower contributions in earlier years.[6] Data from the Office for National Statistics shows that employer and employee contributions to defined contribution schemes as a percentage of salary are lower than for defined benefit schemes. Nearly 90 per cent of defined benefit scheme members receive contributions to their pension pots of 12 per cent and over, compared to 26 per cent of members in defined contribution trust-based schemes, and 13 per cent of members in contract-based schemes (**Figure 4** overleaf). The average employer contribution to an open defined benefit scheme was 15.2 per cent of salary in 2010, compared with 6.2 per cent for open defined contribution trust-based schemes. On average, employees in open defined benefit schemes contribute 5.3 per cent of salary, compared with 2.7 per cent in open defined contribution trust-based schemes.[7]

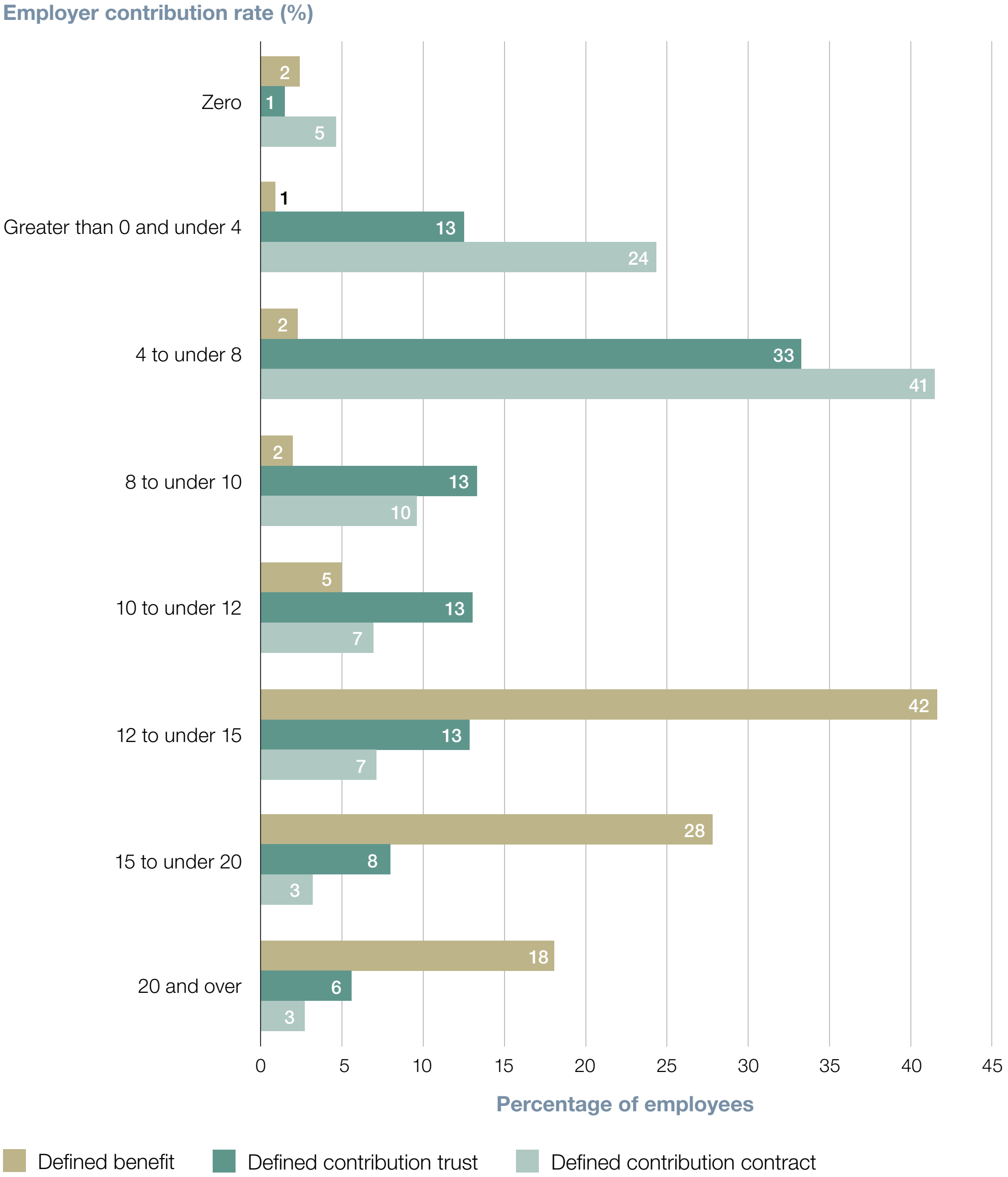
1.8 The taxpayer has a substantial interest in the regulatory system helping to promote good outcomes for members. In 2010-11, tax relief for employer sponsored, private sector defined contribution schemes was an estimated £8.5 billion. This is made up of £6.2 billion tax relief on contributions and £2.4 billion tax relief on investment income from such schemes.[8]

6 C Dobson and S Horsfield, *Defined contribution pension provision*, DWP Research Report 608, Department for Work and Pensions, 2009, P.58.
7 Office for National Statistics, *Occupational Pension Schemes Survey 2010,* October 2011.
8 Estimates provided by HM Revenue & Customs and the Office for National Statistics. The figures do not add due to rounding.

Figure 4

Comparison of employer contribution rates to defined benefit and defined contribution schemes in 2011

Contributions as a percentage of salary tend to be higher in defined benefit schemes



NOTE

1 Figures do not sum due to rounding.

Source: National Audit Office analysis of Office for National Statistics Annual Survey of Hours and Earnings data, 2011

1.9 The shift towards defined contribution schemes also increases longer-term risks to the taxpayer. Outcomes are uncertain, and the state is ultimately liable for providing a basic income for the elderly. If members of defined contribution schemes fail to achieve good financial outcomes from their savings, the public purse may be burdened through means-tested benefit payments and reduced tax receipts from private pension income. The full effect of shifting to defined contribution pension provision will appear over the coming decades as more people with defined contribution pensions retire. The Department estimates that introducing automatic enrolment will increase private pension incomes by between £10 billion and £16 billion by 2050. It estimates that this will save £1 billion in income related benefits by 2050. The Department also estimates that the number of pensioners qualifying for pension credit will fall by 250,000 by 2050.[9]

The regulatory framework for addressing risks from defined contribution schemes

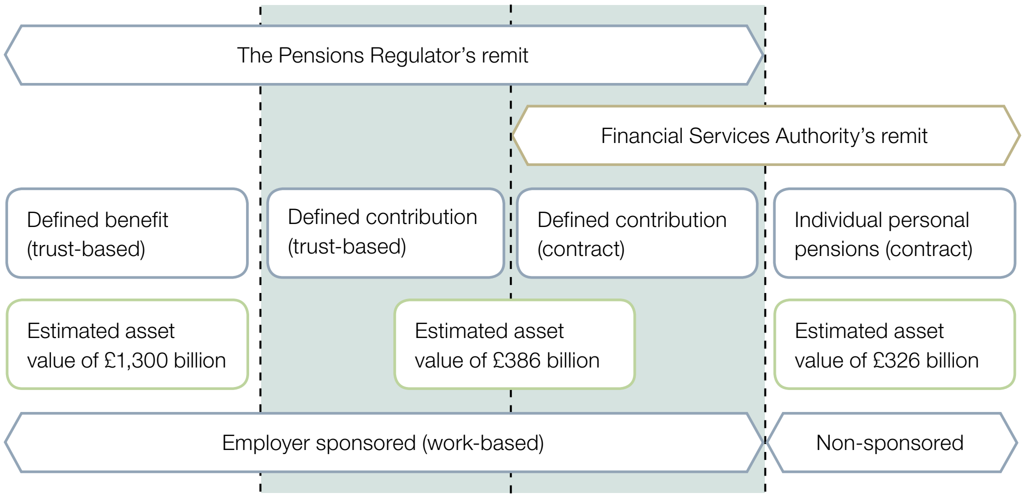
1.10 The Pensions Regulator, an arm's-length body established in April 2005, is responsible for regulating work-based pensions, including defined contribution schemes. Under the Pensions Act 2004 its statutory objectives include:

- to protect the benefits of members of work-based pension schemes, which applies to both defined benefit and defined contribution;
- to promote, and improve understanding of, good administration of work-based pension schemes; and
- under the Pensions Act 2008, to increase the number of employers meeting their duties (including automatically enrolling eligible employees into a pension) and using certain employment safeguards.

1.11 The Pensions Regulator is solely responsible for regulating trust-based schemes. It regulates contract-based schemes with the Financial Services Authority (**Figure 5** overleaf), which regulates most providers of financial services in the UK.

9 P Johnson, D Yeandle and A Boulding, *Making automatic enrolment work – a review for the Department for Work and Pensions*, Cm 7954, Department for Work and Pensions, October 2010.

Figure 5
How regulatory responsibilities are shared



NOTE
1 Estimated asset value in 2010.

Source for estimated asset value: Office for National Statistics, Pensions in the National Accounts – A fuller picture of the UK's funded and unfunded pension obligations, 2012

1.12 The Department and the Treasury are responsible for the regulatory framework within government. The Department shares responsibility for the policy and legislative framework for defined contribution schemes, and for work-based and state pensions generally, with HM Treasury and HM Revenue & Customs. The Department's policy objectives include promoting good retirement income; improving pension scheme regulation and managing risks; providing high-quality pensions analysis; supporting State Pension reform and supporting implementation of automatic enrolment. **Figure 6** summarises the respective responsibilities of the two regulators regarding participants in the defined contribution market.

1.13 The Pensions Regulator is accountable to both Parliament and the Department. The Department funds The Pensions Regulator, partially recovering costs through a general levy on pension schemes set by the Department. While it has no control over the operational activities of The Pensions Regulator, the Department scrutinises and approves its budget and business plans; reviews its financial and operational performance reports; and shares information and analysis on market trends and risks.

Figure 6
Summary of main responsibilities of market participants and regulators

		Main responsibilities of	
Participants	**Participant responsibilities and choices**	**The Pensions Regulator**	**Financial Services Authority**
Member	Choose whether to join; an appropriate fund and contribution level; whether to purchase financial advice, and an income vehicle on retirement.	Regulates disclosure post-joining.	Regulates pre-contractual disclosure in personal products, pre-joining.
Employer	Chooses a suitable scheme (trust- or contract-based); appropriate regular contribution level; and whether to purchase financial advice.	Ensures employers comply with automatic enrolment legislation including payment of contributions.	From 2013, has some disclosure rules following the Retail Distribution Review.
Trustee	Governs trust-based schemes.	Regulates conduct of trustee governance.	Regulates the sale of investments to trustees.
Personal pension scheme provider	Chooses to offer pension schemes to employer market; offers a range of pension funds to members and may choose to offer retirement options to members.	Regulates some aspects of conduct of managers of work-based personal pension schemes, including: contribution payment monitoring; late payment reporting; and member disclosure.	Prudential and conduct regulation of the firms that provide, promote, market, advise on or sell personal pensions and annuities, including member disclosure. Regulates the establishment operation and winding-up of personal pension schemes.
Third-party administrator	Employed by some schemes to manage contributions and pension records.	Promotes understanding of good administration of work-based schemes.	Regulates activities such as administering contracts of insurance.
Intermediaries	Provide professional services to employers, employees and trustees.	None.	Regulates independent financial advisers. Regulates fund managers.

Source: National Audit Office analysis

Part Two

The Pensions Regulator’s approach and activities in the wider regulatory system

2.1 This part sets out how the regulatory system addresses risks to defined contribution scheme members, and how The Pensions Regulator acts within this system, including how it uses its powers and resources. In assessing value for money we have considered whether:

- The Pensions Regulator has sufficient skills and market information to adopt a risk-based approach to deploy its resources;
- The Pensions Regulator has an effective framework to measure its performance in relation to meeting its statutory objectives; and
- the wider regulatory system within which The Pensions Regulator operates is well-integrated, with a common risk framework supported by a strong evidence base, clear accountabilities and responsibilities, and clear ways to intervene to address risks through regulatory action if necessary.

What regulation seeks to achieve

2.2 The Pensions Regulator’s objectives could be clearer. In particular, it’s statutory objective to protect the benefits of members of defined contribution schemes is open to wide interpretation, and has not been translated into intermediate objectives which are more specific and capable of measurement.

2.3 At the system level, it is not clear what regulation of defined contribution schemes seeks to achieve. The Pensions Regulator and the Financial Services Authority have their own statutory objectives, but there are no overarching regulatory system objectives against which overall regulatory action can be measured.

The regulatory system

2.4 Because responsibilities are shared, the regulatory system needs effective working arrangements between regulators and the departments that are responsible for setting the legislative frameworks within which they operate. A Memorandum of Understanding between the regulators sets out their respective roles, particularly regarding contract-based schemes where they share regulatory responsibilities. At The Pensions Regulator's instigation, the two regulators, the Department and the Treasury established a senior group on defined contribution schemes in October 2009, which meets every two months. Effectiveness of joint-working arrangements will become more complex when the Financial Services Authority is succeeded by the Financial Conduct Authority and the Prudential Regulatory Authority, both of which will have responsibilities for regulating contract-based schemes.

Assessing risks to members

2.5 Some market activities are not directly covered by current regulatory arrangements. Advice to businesses is unregulated, which means that employers may receive poor quality or partial advice and make decisions that are not in members' best interests. Where third-party administrators provide poor service, only trustees can take direct action. The Pensions Regulator can issue third-party improvement notices where an administrator causes a trustee to breach statutory duty. The Financial Services Authority regulates activities such as administering contracts of insurance. Where administration of a regulated activity is outsourced to a third party, the regulated provider retains overall responsibility.

2.6 The Pensions Regulator has undertaken detailed analysis of risks to defined contribution scheme members, in 2007 and updated in 2010 supported by analysis commissioned from Deloitte. But the two regulators do not have a common approach to assessing risks and therefore may not agree on the most appropriate course of regulatory action. The senior level group has not established a joint register for managing risks to members. The absence of a common risk framework could lead to inconsistent regulation of different schemes which could unduly influence the choices of employers, and makes it difficult to assess whether there are any gaps in the existing regulatory coverage.

2.7 A common risk framework also requires effective sharing of information between the regulators, to provide a sound evidence base for regulatory decision-making. The Memorandum of Understanding between The Pensions Regulator and the Financial Services Authority provides for information sharing, and the regulators are currently reviewing the effectiveness of these arrangements.

The Pensions Regulator's powers under the system

2.8 The Pensions Regulator has powers to regulate work-based pension schemes under the Pensions Acts of 2004, 2008 and 2011 (**Figure 7**), which include:

- collecting information, primarily through scheme returns;
- issuing codes of practice, guidance and discussion papers; and
- more formal action, such as acting to protect member benefits through Improvement Notices requiring corrective action; fining employers who fail to maintain contributions; prohibiting and replacing trustees who are not fit and proper; imposing fines for statutory breaches; and prosecuting certain offences in the criminal courts.

2.9 The division of responsibilities between the regulators reflects their individual statutory powers. In trust-based schemes, The Pensions Regulator is responsible for, and its powers (both informal and formal) are clearly directed towards, the central role of trustees. In contract-based schemes, the Memorandum of Understanding provides for the Financial Services Authority to lead in areas involving market participants that it has powers to regulate, particularly insurance companies who contract directly with members of schemes, and financial advisers where they provide advice to individuals. The Memorandum of Understanding provides for The Pensions Regulator to lead in relation to employers.

2.10 Because there is insufficient clarity regarding overarching objectives and risk assessment, it is unclear whether The Pensions Regulator has an appropriate level and range of powers to achieve those objectives. It has the statutory objective to protect members' benefits of both trust-based and contract-based schemes. The Pensions Regulator can issue guidance on any aspect of work-based pension schemes, although its ability to act formally when guidance is not sufficient depends on its statutory powers. It has a range of options for dealing with trust-based schemes, for example removing and replacing trustees. But it has fewer options to intervene directly in contract-based schemes, where regulatory responsibilities are shared with the Financial Services Authority. The Pensions Regulator's statutory powers allow it to address breaches of statutory responsibilities, generally on a case-by-case basis. There is no equivalent of the regulatory licences of other sectors, or the rule-writing powers of the Financial Services Authority, to allow The Pensions Regulator to set conditions of expected behaviour across the market, and procedures for regulatory action if conditions are not met. An assessment of whether existing powers are sufficient requires greater clarity at the system level in knowing what regulation seeks to achieve.

Figure 7
Summary of The Pensions Regulator's powers and activities

Participants	Powers	Activities
Member	None.	None.
Employer	Can enforce employer compliance with automatic enrolment legislation and timely payment of contributions.	Communicates with every employer. Engages with employers through providing guidance.
Trustee	Can appoint trustees where reasonable. Can prohibit, suspend and disqualify trustees where not fit and proper. Can issue Improvement Notice or civil penalties for a breach of pensions statute. Can seek recovery of unpaid scheme contribution debt. Can wind-up a scheme. Can demand information and investigate activities. Can seek court orders to retain misuse or misappropriation of assets.	Provides guidance and an online toolkit to improve trustee knowledge and understanding. Demands information and investigates alleged governance failings. Works with existing trustees to improve governance. Appoints additional or replacement trustees. Prohibits unfit trustees.
Personal pension scheme provider	Can recover scheme contribution debt. Can seek court orders to retain misuse or misappropriation of assets.	Lobbies market for transparent and fair charging structure.
Third-party administrator	Can issue a third-party notice where third party causes trustee to breach statutory duty. Can provide information, education and assistance to those involved in the administration of schemes.	Produces good practice guidance on scheme record keeping.
Intermediaries	Can provide information, education and assistance to those advising the trustees, managers or employers of schemes.	Intermediary campaign on automatic enrolment.

Source: National Audit Office analysis

Accountability and performance measurement

2.11 In practice, the division of responsibilities provides clarity where the regulatory focus is on providers, or employers, or trustees. But it is less clear in establishing which regulator is responsible for achieving specific regulatory outcomes from the perspective of scheme members, where their responsibilities overlap. Although the senior level group considers these matters, there is currently no single body responsible for leading on regulation of defined contribution schemes, or accountable for its delivery.

2.12 The Pensions Regulator has built on its risk work to identify six 'good member outcomes' for defined contribution scheme members (**Figure 8**). But the absence of a common risk framework means that it is unclear how far the good member outcomes, or the factors influencing them, fall within the scope of regulation. There is no overarching system for measuring performance across the responsibilities of both The Pensions Regulator and the Financial Services Authority, to measure the impact of regulation in securing better outcomes for members. The Financial Services Authority stresses that it measures its performance against its own statutory objectives across all of the markets it regulates.

Figure 8
The Pensions Regulator's expectations

Six good outcomes for members of defined contribution schemes

Appropriate investment decisions

Appropriate contribution decisions

Efficient and effective administration

Protecting assets

Value for money

Appropriate decisions on converting pension savings into retirement income.

Six principles for good workplace defined contribution schemes

Providers design schemes that are durable, fair and deliver good outcomes for members.

Providers establish an initial comprehensive scheme governance framework, with clear accountabilities and responsibilities agreed and made transparent.

Those who are accountable for scheme decisions and activity understand their duties and are fit and proper to carry them out.

Providers govern and monitor schemes effectively, throughout their full life cycle.

Providers administer schemes well with timely, accurate and comprehensive processes and records.

Providers communicate with members well, so members can make informed decisions about their retirement savings.

Source: The Pensions Regulator, Enabling good member outcomes in work-based pension provision, January 2011; The Pensions Regulator, Six principles for good workplace DC, December 2011

The work of The Pensions Regulator

The Pensions Regulator's approach

2.13 During 2011, The Pensions Regulator published a discussion paper consulting on its strategic approach to regulating defined contribution schemes, including its view of what represents good outcomes for members. In December 2011, it published its six principles for well-run defined contribution schemes (Figure 8). It has now developed a plan – the Defined Contribution Programme – to support this. In February 2012, The Pensions Regulator published its strategy for automatic enrolment and the regulation of defined contribution schemes. In June 2012, it set out detailed expectations of what good service looks like for members of both trust- and contract-based defined contribution schemes.

2.14 The Pensions Regulator has issued guidance and codes of practice setting out its expectations across a wide range of defined contribution scheme activities. Since 2007, it has published ten guidance notes regarding defined contribution schemes, together with one code of practice; five regulatory statements; three regulatory tools for employers and employees; and undertaken seven pieces of research and analysis.

2.15 The Pensions Regulator aims to provide a targeted and proportionate approach to regulation:

- The Pensions Regulator has segmented its market, which increases how well it understands and targets the risks that it identifies. It has categorised five market segments (four trust-based segments, one contract-based segment), according to scheme size and investor type, and in each case identified the intermediary whom it seeks to influence. It is, however, difficult for The Pensions Regulator to target less engaged employers and trustees (paragraphs 3.5 and 3.25).
- In trying to regulate proportionately, according to the risks in the market, The Pensions Regulator tries to 'educate, enable and enforce' by using guidance and support wherever possible, and enforcement action only as a last resort. Figure 7 summarises its regulatory activities.

The Pensions Regulator's resource use and capability

2.16 As part of the Government's Comprehensive Spending Review 2010, the Department required The Pensions Regulator to prepare plans reflecting a 25 per cent reduction in its funding from levy-payers between 2010-11 and 2014-15. This will reduce the levy paid by schemes. However, its overall costs will fall by less than this since the requirement excludes the budget to meet its duties under the Pensions Act 2008. The Pensions Regulator has identified and implemented some measures to reduce costs, for example developing, and encouraging scheme members to complete online returns, which has reduced data processing costs.

2.17 The stakeholders we interviewed generally considered that The Pensions Regulator is now balancing its defined benefit and defined contribution regulatory activities better. However, several considered that it has taken longer than necessary to develop its defined contribution schemes strategy (**Figure 9**). It is difficult to measure quantitatively, in time or cost, how far The Pensions Regulator has shifted its focus from defined benefit to defined contribution schemes, as it does not separately record its spending on these activities. For this report, The Pensions Regulator estimated that 22 per cent of its activity in 2011-12 will have been on defined contribution schemes, which equates to £6.7 million, and expects this to increase in 2012-13 to 32 per cent.

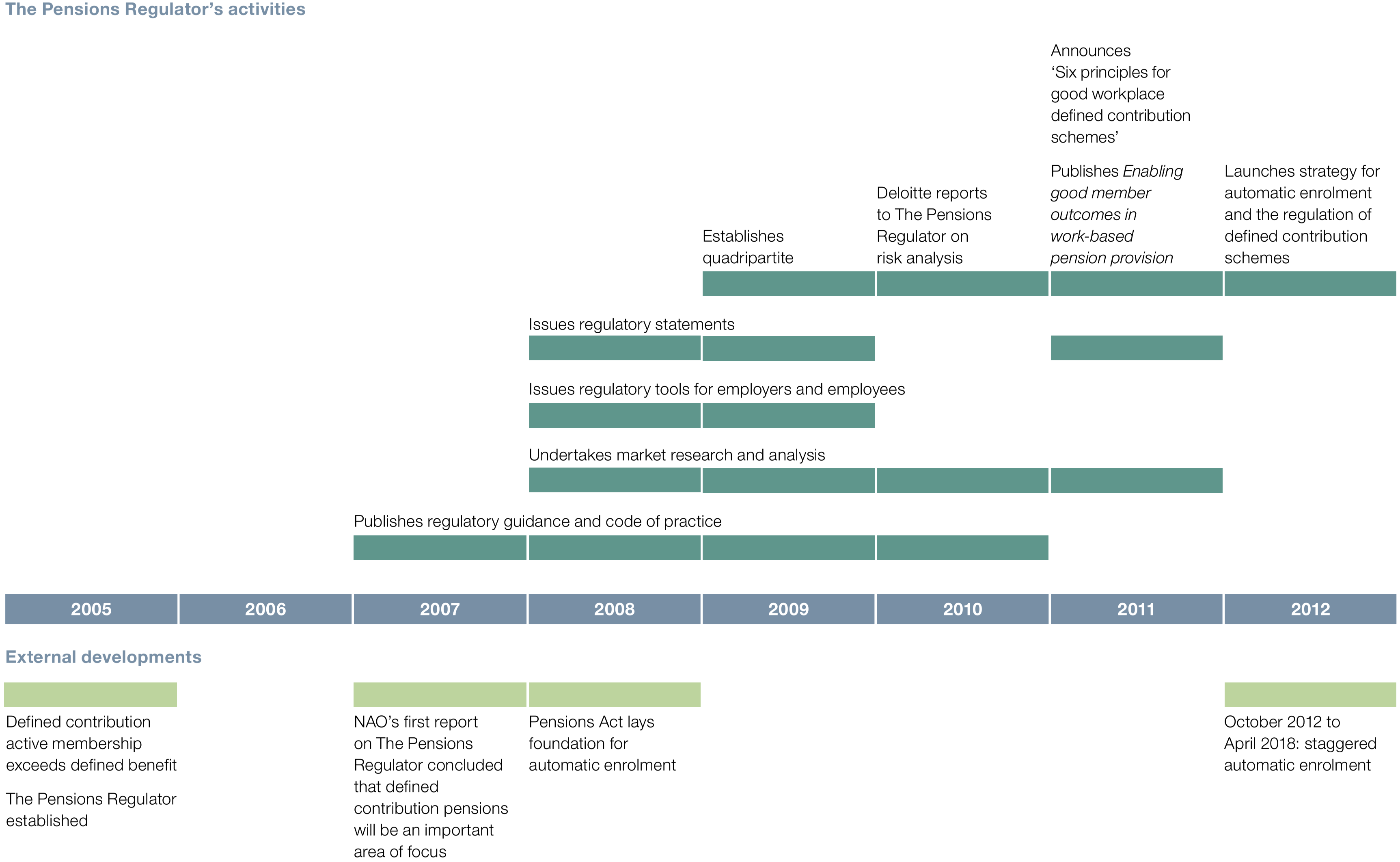
2.18 Although it keeps its skills under review, The Pensions Regulator has not formally reviewed its longer-term skills needs (for example through independent external review) regarding defined contribution schemes. It predominantly regulates defined benefit and trust-based schemes, and our interviewees considered it to be highly capable in this regard. Although it does not lead in regulating contract-based schemes, it needs sufficient skills in this area to be able to respond effectively to market developments and, from time to time, issue guidance cross-cutting all types of schemes. An issue that was raised during our stakeholder discussions was that The Pensions Regulator needs stronger knowledge and experience of contract-based schemes, while also drawing in new people to apply fresh solutions to problems. It has made use of inward secondments and consultancy support, and in February 2012 it began an internal analysis of skills needs in this area.

The Pensions Regulator's evidence base

2.19 The Pensions Regulator has worked to better understand the market and the risks to members' financial outcomes. It has widened its information on defined contribution schemes, and in 2011 had basic scheme data on 95 per cent of defined contribution schemes by membership, compared with 32 per cent when we reported in 2007.

2.20 The Pensions Regulator communicates through a combination of written and face-to-face methods. It uses information from the Department's surveys of employer attitudes, and undertook a survey of members in 2011. The Pensions Regulator has developed an annual governance survey which provides valuable quantitative information on the quality of governance of trust-based schemes. An issue that was raised during our stakeholder discussions was that it could engage more effectively to understand complex market issues, and it is currently planning to establish a technical working group to help address this.

Figure 9
Timeline of key events, defined contribution schemes



Source: National Audit Office analysis

2.21 The Pensions Regulator sets performance targets and reports against these using indicators agreed annually with the Department (**Figure 10**). Some of the 2010-11 targets were not met partly because it curtailed or cancelled several planned educational activities in 2010 as part of a government-wide freeze on communication campaigns. The indicators focus on the areas that The Pensions Regulator can most directly influence, which helps in demonstrating accountability. It is challenging for any regulator to measure the outcomes that it seeks to achieve, partly because of the difficulty in measuring what would happen in the absence of regulatory action. There are, however, some limitations with The Pensions Regulator's performance measurement:

- most indicators are measured through annual governance surveys of trust-based schemes. Contract-based schemes do not feature because the Financial Services Authority leads in regulating these;
- it can be difficult to distinguish the effects of surveying different people from year to year from genuine performance changes; and
- indicators have changed from year to year, and tend to measure processes or activities, such as toolkit modules completed or schemes reporting having mechanisms for risk management, rather than the improved member outcomes that The Pensions Regulator seeks to achieve through better administration for example.

2.22 The Pensions Regulator has set out in its new Corporate Plan for 2012-2015 that it will develop additional intermediate and more outcome-focused measures to assess compliance by schemes with the principles and features for defined contribution schemes and the extent to which members receive demonstrably better pension outcomes.

Figure 10
Measures of performance

The Pensions Regulator met 6 of its 11 targets between 2008-09 and 2010-11

Measure	Indicator	Data source	2008-09 (%)	2009-10 (%)	2010-11 (%)
Understanding risks	Percentage of trustees reporting a good or very good understanding of risks to defined contribution schemes	Governance survey and perceptions tracker[2]	Met Target: 78 Reported: 78	Met Target: 80 Reported: 80	Met Target: 80 Reported: 83
Investment performance	Percentage of trustee boards which assess the performance of the investment fund or funds offered to members at least every three years	Governance survey	Missed Target: 85 Reported: 72	[1]	[1]
Retirement options	Percentage of (i) schemes saying they informed retirees of open market options; (ii) (in 2009-10) retirees saying they were informed	Governance survey	Missed Target: 80 Reported: 68	Met **Schemes:** Target: 70 Reported: 72 **Retirees:** Target: 70 Reported: 84	Met Target: 74 Reported: 79
Charges	Percentage of schemes whose trustee board assesses the level of fund charges at least every three years	Governance survey	Missed Target: 80 Reported: 60	[1]	[1]
Member communications	Percentage of trustees assessing their scheme communicates well or very well with members	Governance survey	[1]	Met Target: 85 Reported: 87	Missed Target: 80 Reported: 76
Default funds	Percentage of trustees feeling that their scheme's default fund reflected the risk profile of scheme members	Governance survey	[1]	[1]	Missed marginally Target: 81 Reported: 79

NOTES

1 No target was set for the year.

2 The perceptions tracker is used by The Pensions Regulator to measure stakeholder views of its performance over time.

3 Only includes Key Performance Indicator Targets which relate exclusively to defined contribution pension provision.

Source: The Pensions Regulator

Part Three

Outcomes for defined contribution scheme members

3.1 This part of the report examines evidence on those factors affecting member outcomes which can be influenced by regulation. We consider the extent to which choices made by members and their representatives can influence outcomes; the variation in outcomes members may experience; and whether regulatory activities are effectively mitigating potential problems. In assessing value for money we have sought to consider whether there is unwarranted variation in outcomes, or in the factors that contribute to those outcomes, for scheme members, given broadly similar contribution levels and investment performance.

Factors which affect outcomes for members

Choices by members and their representatives

3.2 There is a wide range of factors that contribute to the outcomes that defined contribution scheme members achieve from their investment. Some are influenced by the choices that members make while accumulating funds, particularly regarding how much they choose to contribute and their choice of investment fund. When converting to an annuity, key factors include member choices of annuity providers and whether to take a lump sum before converting the savings. **Figure 11** outlines the effect certain member choices and external factors can have on private pension income.

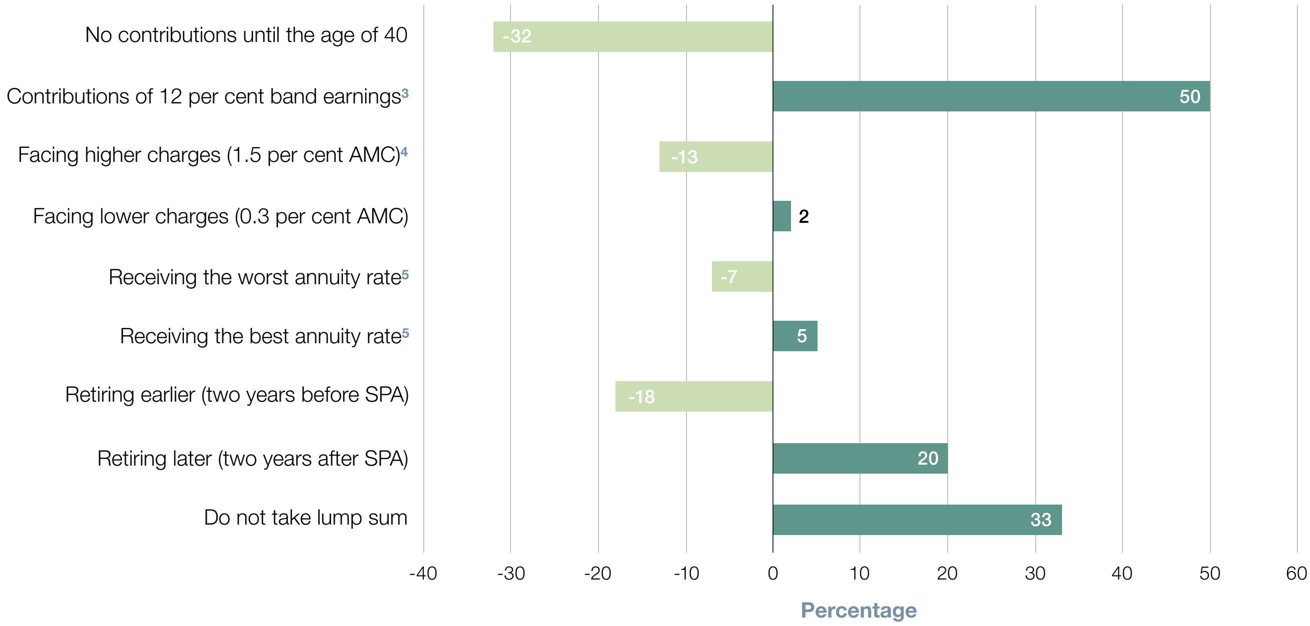
3.3 Member awareness of choices varies. Of members surveyed by The Pensions Regulator in 2011, most were aware that they could increase contributions, but one-third had no idea they could change funds.

3.4 Factors influencing outcomes also include decisions and actions taken by others. Trustees have statutory duties to ensure that schemes are operated in their members' interests. Employers can also play an important role, particularly in how they engage with providers in setting up contract-based schemes where, although providers are regulated by the Financial Services Authority and must abide by Conduct of Business and Treating Customers Fairly rules, there are no trustees to protect member interests. The choice that members have when joining schemes depends on decisions made by the employer and provider on the type and range of options offered to members. In 2011, The Pensions Regulator found that 30 per cent of schemes surveyed offered only one type of fund to members.

Figure 11
How member choices can impact private pension income

Decisions about contribution levels have the largest impact on member outcomes

Impact on private pension income for the median earning man[1] on reaching the state pension age (SPA), percentage difference from the baseline[2]



NOTES

1 Aged 25 in 2012, initially earns £20,000, retires in 2055 aged 68 with a salary of £22,000 (in 2011 earnings terms). Between the ages of 30 and 68, he and his employer contribute to a defined contribution pension.

2 Baseline assumptions: employees are members of the NEST pension scheme from age 30 until they retire; total employer and employee contributions consist of 8 per cent of band earnings; charges include a 1.8 per cent charge on pension contributions and a charge of 0.3 per cent on the funds under management each year; employees purchase a single life, level annuity at retirement; individuals take 25 per cent of the final pension fund as a tax free lump sum and annuitise the remaining 75 per cent of the fund; individual retires at state pension age.

3 Band earnings are the range over which employee and employer pension contributions are made. The assumption of contributions of 12 per cent is higher than the required minimum contributions of 8 per cent under automatic enrolment from October 2018 onwards.

4 Annual management charge.

5 According to the Money Advice Service comparison tables, on 6 June 2011.

Source: Pensions Policy Institute, Closing the gap: the choices and factors that can affect private pension income in retirement, February 2012

3.5 The Pensions Regulator leads in engaging with employers about their pension schemes, through a combination of education and enforcement. This includes making sure that employers comply with their obligations under the Pensions Act 2008. There is no formally collected data on employer engagement and capability. Engaging with employers will become more important after automatic enrolment, which could increase the number of employers providing pensions from 100,000 to one million, and increase the proportion of employers offering pensions who have limited engagement with, and understanding of, them.

Advice

3.6 Better capability of members, and of those acting on their behalf, can improve the quality of decision-making, which plays a major role in determining members' financial outcomes. Many members do not engage well with, or understand, their pension. Pensions are complex and even individuals with a strong financial background find it difficult to make informed decisions. The Pensions Regulator's 2011 members survey found that:

- "thirty-four per cent of members surveyed have no specific goal for their pension or have not thought about it;
- sixteen per cent of members are paying money into something they don't know the basic workings of and therefore are blind to the risks; and
- thirty-five per cent of members surveyed knew very little or nothing about their pension that they would need to know, to plan for the future".[10]

3.7 The complexity of pensions and limitations in the capability of members, employers and trustees makes access to good quality impartial advice crucial for member outcomes. This is particularly the case for members choosing an annuity, which is a one-off, irreversible decision. There is evidence that:

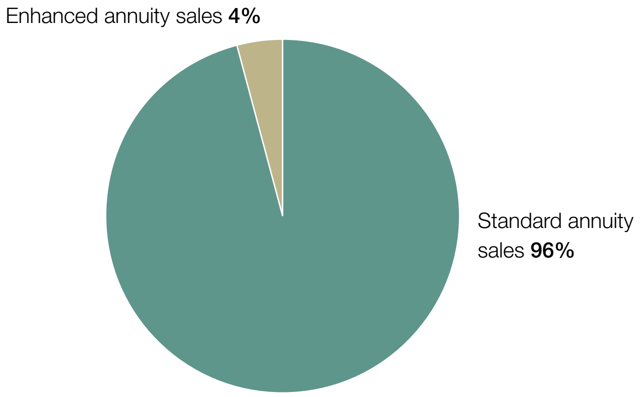
- employers, friends and family, and independent advisers are of equal importance as sources of pension advice, according to The Pensions Regulator's survey of members; and
- members who seek independent advice are more likely to secure higher, enhanced annuities as a result (**Figure 12**).

10 The Pensions Regulator, *Member Survey*, March 2011.

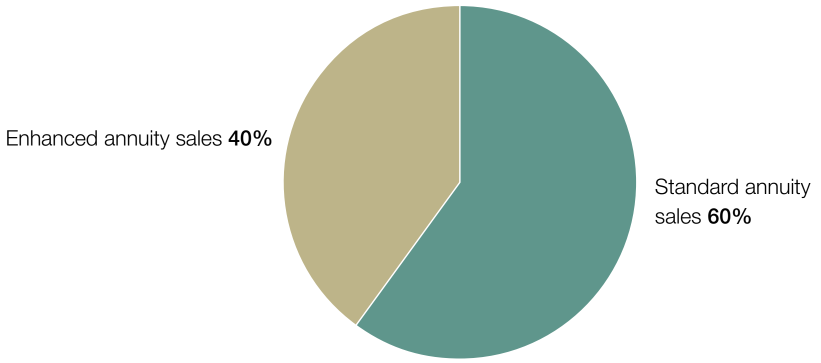
Figure 12
Proportion of the total value of annuity sales broken down by distribution channel, 2011

Members who purchase an annuity through an intermediary are more likely to secure an enhanced rate

Non-intermediated annuity sales by value



Intermediated annuity sales by value



NOTE

1 Intermediated sales: those sold through independent financial or whole of market advisers.

Source: National Audit Office analysis of Association of British Insurers data, 2011

3.8 Employers make important decisions, particularly at the beginning of the pension life cycle. Employers choose the type of pension scheme (contract or trust) to provide for their employees and an appropriate contribution level. There is evidence that larger employers are more likely than smaller employers to use employee benefits consultants and less likely to use independent financial advisers (**Figure 13**).

Variability in factors affecting outcomes

3.9 Office for National Statistics data[11] indicates considerable variation in the wealth held in defined contribution schemes by different groups of members. The average (mean) wealth per membership between 2006 and 2008 was £26,000. Within this, the average wealth for men was £34,000, compared to £15,200 for women. The median wealth per membership was £6,500, indicating a large proportion of memberships with pots smaller than the mean.

Contributions

3.10 Contribution levels, and the length of time over which contributions are made, have the biggest relative impact on members' financial outcomes. Saving 12 per cent of earnings into a pension compared with 8 per cent can increase private pension income by 50 per cent.[12]

3.11 There is considerable variability of employer contribution levels within defined contribution schemes. Three in ten members of contract-based schemes receive employer contributions of between zero and 4 per cent of earnings, while two in ten contract-based scheme members receive employer contributions of over 10 per cent (Figure 4).

Investment decisions

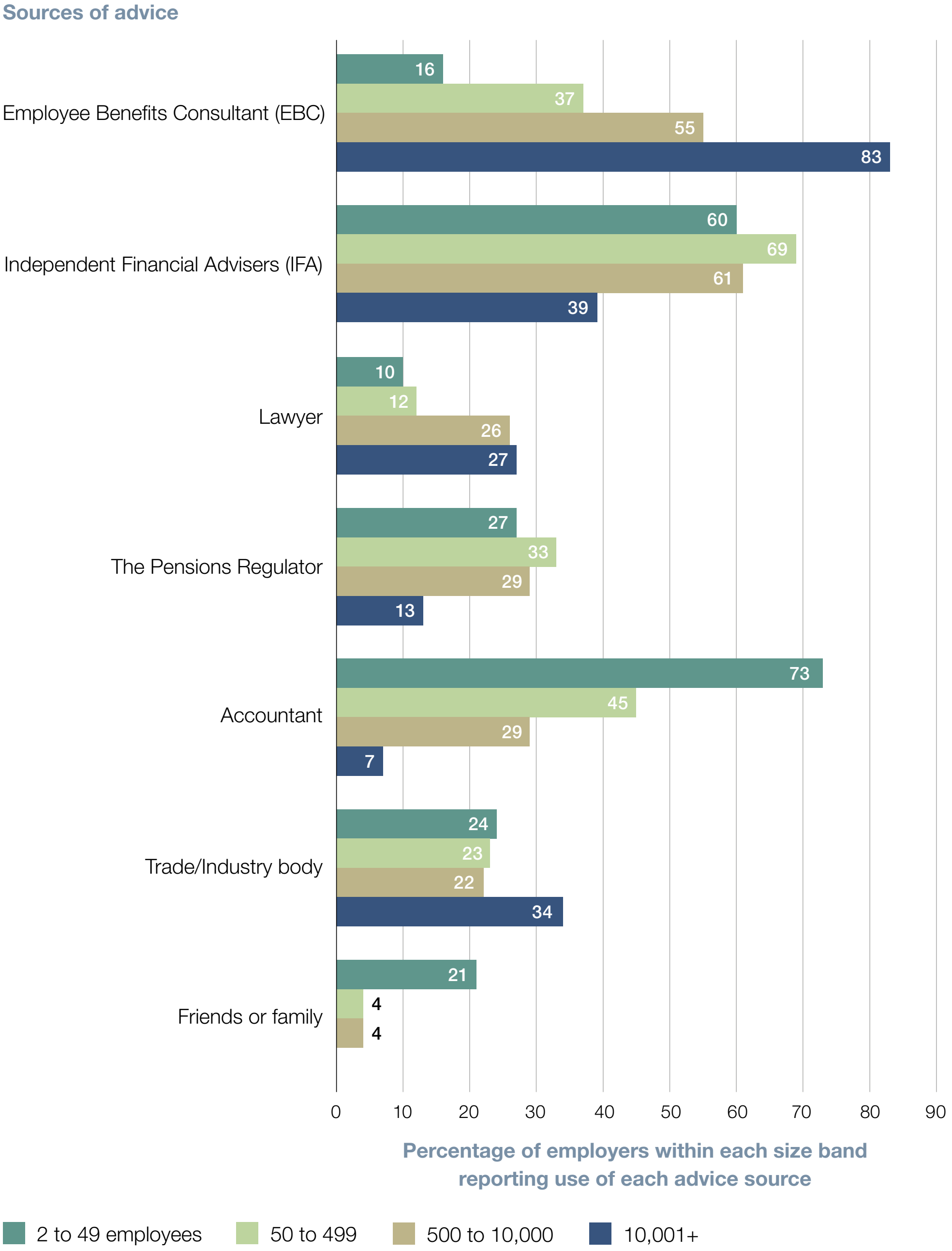
3.12 The design and selection of investment funds is also important, to ensure that contributions are invested to balance growth and the risk profile of individual members. After the introduction of automatic enrolment, all qualifying schemes will be required to provide a default option for members who do not want to choose a fund. According to most estimates, around 80 per cent of members invest in the default fund. Employers can work with scheme providers to make sure that the default fund reflects the risk profile of all members. Our interviewees gave positive comments about recent guidance by the Department on the design of default funds.

11 Office for National Statistics, *Wealth and Assets Survey 2006-2008,* December 2009. Data is correct at the time of our publication but may be subject to review.

12 Pensions Policy Institute, *Closing the gap: the choices and factors that can affect private pension income in retirement*, February 2012.

Figure 13
Sources of advice for different sized employers when choosing a scheme

Sources of advice vary according to employer size



NOTES

1 Other sources of advice included in the survey are not included in this analysis.

2 Totals across different sources will add to more than 100 per cent.

Source: National Audit Office analysis of National Employment Savings Trust data, Employer decision-making survey, 2009

3.13 The Pensions Regulator reported that, in 2010-11, 79 per cent of trustees surveyed considered that their scheme's default fund was suitable for the risk profile of the scheme's members. This figure was below The Pensions Regulator's target of 81 per cent. Of the trust-based schemes surveyed, 47 per cent reported regular review of their investment strategy in 2011, compared with 56 per cent of schemes in 2009. Neither The Pensions Regulator nor the Financial Services Authority collect comprehensive data on the actual returns (after fees) for members of defined contribution pension schemes and how returns vary across the different segments of the defined contribution market.

Charges

3.14 The level of fees and charges can have a considerable impact on the size of the pension fund. The maximum allowable annual management charge for a stakeholder pension scheme is 1.5 per cent for ten years and 1 per cent thereafter. The Pensions Policy Institute compared these with the National Employment Savings Trust (NEST) scheme[13] charges of 0.3 per cent for annual management and 1.8 per cent on contributions, and estimated that the lower NEST charges could lead to a higher private pension income for the median earning man of around 13 per cent, or 17 per cent higher without contribution charges.[14] The Department expects that NEST's charges will act as a benchmark across the pensions industry which should keep charges low.

3.15 There is no comprehensive data on actual charging levels for defined contribution scheme members. Research commissioned by the Department in 2010 found a range of annual management charges in contract-based schemes of between 0.3 and 1.5 per cent (compared to a median for trust-based schemes of 1 per cent), which can be increased by additional charges.

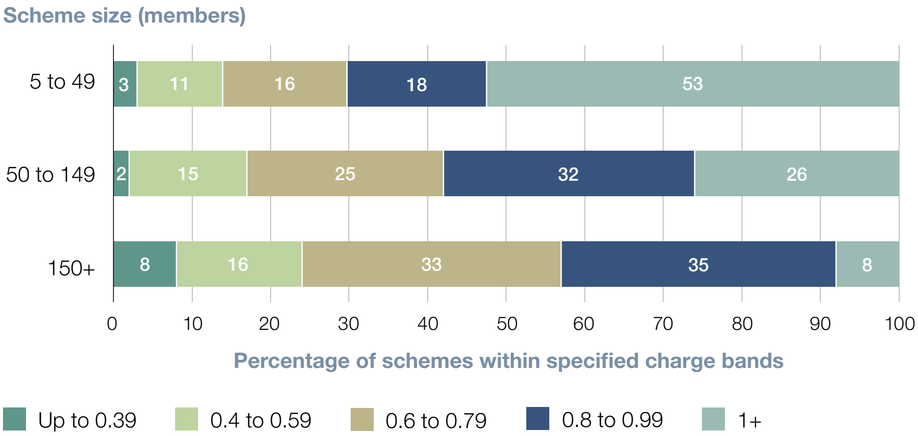
3.16 The Department's research shows that large schemes are more likely to achieve 'economies of scale' whereby their unit costs are lower than those of smaller schemes (**Figure 14**). In 2005, the Pensions Commission noted that large occupational schemes can have explicit charges as low as 0.2 per cent of fund value each year, compared with up to 0.5 per cent for small occupational schemes.

13 Introduced as a qualifying scheme under automatic enrolment.

14 Pensions Policy Institute, *Closing the gap: the choices and factors that can affect private pension income in retirement,* February 2012. Not all stakeholder schemes charge the maximum allowed.

Figure 14
Scheme charges

Schemes with fewer members tend to have higher unit charges



NOTE
1 Figures do not sum due to rounding.

Source: A Croll, E Vargeson and A Lewis, Changing levels and structures in money-purchase pension schemes: Report of a quantitative survey, DWP Research Report 630, Department for Work and Pensions, 2010.

3.17 Charges are not always transparent, making it difficult for members and their representatives to assess whether charges are justified by fund performance and risk levels. Charging structures can be complex, and measures such as 'total expense ratio'[15] are not always directly comparable. We found widespread agreement among our interviewees that employers and members experience a lack of transparent and accessible information to allow informed decisions about value for money. Surveys by The Pensions Regulator in 2011 found that:

- thirty-two per cent of members surveyed answered 'don't know' when asked if they knew whether their charges represent value for money; and
- there is wide variation among schemes in understanding charges, with 19 per cent of schemes surveyed unable to judge whether charges were value for money.

15 Total costs to an investor as a percentage of average assets held over a year.

Annuities

3.18 For most people, converting a pension fund into a retirement income is one of the biggest financial decisions they will make. Choices include how much pension fund to convert into an income; which retirement income product to use; and whether or not to use the open-market option (the right to shop around for the most competitive rate).

3.19 Shopping around for an annuity can increase private pension income. MGM Advantage estimates that in December 2011 the average difference in the income paid between the top and bottom quartile conventional annuity rates on a £50,000 pension pot was 19 per cent for men and 22 per cent for women.[16] Based on the size of the current annuity market and an estimate of what a proportion of defined contribution customers will lose if they do not secure the right type of annuity at the right price, research estimates people retiring each year could lose retirement income worth between £500 million and £1 billion.[17]

3.20 Providers are legally required to inform members that they can purchase annuities on the open market between four and six months before retirement. In 2009, The Pensions Regulator found that 98 per cent of trust-based schemes offered the open-market option, but some 30 per cent of schemes had at least one breach of the retirement disclosure regulations, and only one in four members used the open-market option. In 2011, The Pensions Regulator found that 30 per cent of members surveyed could not recall being informed of the open-market option.

3.21 In March 2012, the Association of British Insurers established a compulsory code of conduct for their member firms. The code required providers to give clearer and more consistent communications to customers about their options. The requirement will give greater transparency about varying financial outcomes in the annuity market, although not all trust-based schemes are subject to the code.[18]

Governance

3.22 Good administration and governance is important to ensure members' interests are well represented and, for example, that assets are not lost through poor record-keeping or delays. It is also important that funds held in schemes for members are well protected.

3.23 Formal representation of members' interests varies by scheme type. In trust-based schemes a board of trustees administers the scheme for members. Members of contract-based schemes have no formal representation since the contractual relationship is between the member and the provider. Employers can establish a governance committee to represent members' interests, but these lack the same

16 Annuity Index, Press Release, Marine and General Mutual Life Assurance Society, 23 January 2012.
17 National Association of Pension Funds and Pensions Institute, *Treating DC scheme members fairly in retirement?*, 2012, p.26.
18 The code applies where the provider issues communications direct to members, or if they go via the trustee and the trustee asks the provider to adhere to the code.

legal status. Governance and internal control arrangements among smaller trust-based schemes tend to be considerably weaker than those among schemes as a whole, according to The Pensions Regulator's governance surveys.

3.24 There is considerable variation in trustees' knowledge and capability to act in the best interests of members. While 84 per cent of large schemes in 2011 had documented or formally assessed their trustees' learning needs, only 34 per cent of small schemes had done so.

What regulation seeks to influence

Progress reported by The Pensions Regulator

3.25 The Pensions Regulator can influence trustees and has worked to raise quality through a code of practice and an online toolkit to develop trustee knowledge and understanding. It has achieved 91 per cent awareness of its toolkit among schemes surveyed in 2011, while 88 per cent of trustees surveyed reported a 'good' or 'very good' understanding of risks to schemes, up from 77 per cent in 2010. There are, however, many trustees (around 140,000) and The Pensions Regulator finds it more difficult to reach less engaged trustees, with 46 per cent of defined contribution schemes surveyed in 2011 reporting not having used the toolkit. In 2011-12, out of 80,000 defined contribution scheme trustees that the toolkit is aimed at, only 4,400 had registered to use it.

3.26 The Pensions Regulator has successfully reduced the duration of scheme wind-up, with 86 per cent of defined contribution scheme wind-ups in 2010-11 completed within two years, exceeding its target of 70 per cent. It has issued guidance on record-keeping and, in 2011, 99 per cent of trust-based, and 76 per cent of contract-based schemes surveyed were aware of this guidance. Trust-based schemes were more likely to have read the guidance in detail and taken action (42 per cent) than contract-based schemes (14 per cent). The Pensions Regulator has also helped to improve internal controls. Awareness among scheme providers surveyed, of what is expected from them, increased from 48 per cent to 74 per cent between 2009 and 2011.

3.27 The Pensions Regulator has also made some use of its enforcement powers to protect members' benefits. In December 2011, it successfully obtained a High Court ruling that the use of reciprocal loans was invalid. This protects future members, as well as having potential to recover existing members' funds already lost. The Pensions Regulator can also take enforcement action to remove and replace trustees, although it uses this power only where trustee performance has been very poor. In 2010-11, it replaced two trustees for not being fit and proper.

Limitations in The Pensions Regulator's ability to act on variation

3.28 Lack of clarity in the overall scope of the regulatory framework makes it difficult to be clear to what extent members and representatives are expected to protect themselves. Similarly there is a lack of clarity within the framework regarding what constitutes acceptable market variation, as opposed to unwarranted variation which may justify regulatory intervention.

3.29 The Pensions Regulator's good member outcomes include 'value for money', where fees and charges are an important factor. It has undertaken work to improve its understanding of charges, which confirmed problems regarding the complexity of charging structures. The Pensions Regulator, however, has no power to act regarding charges beyond issuing guidance. In reviewing charges the Pensions Regulator found that it lacks the powers necessary to collect the information it needs to understand where the risks are greatest, as insurance companies are regulated by the Financial Services Authority. However, following the The Pensions Regulator's public call to action on charges, the National Association of Pension Funds has established an industry group to consider how best to disclose pension scheme costs to employers and has recently issued a report and an industry-led code of conduct on the disclosure of these charges. The Pensions Regulator will then consider whether further disclosures should be required for the schemes they regulate. The Department also has reserve powers to impose a charge cap if the market mechanism and industry action are ineffective at ensuring a properly functioning market place.

3.30 The Pensions Regulator actively monitors the market for emerging risks and has identified that:

- there are fewer restrictions on 'master-trust' multi-employer schemes[19] entering the market than on equivalent schemes regulated by the Financial Services Authority, which presents risks with regard to the safeguarding of members' assets. In contrast to other financial service providers, 'master-trusts' do not have to meet minimum standards as set out by the Financial Services Authority. The Pensions Regulator is presently reviewing its regulatory powers with respect to 'master-trusts'; and
- in some schemes money changes hands many times through the investment chain, in some parts of which funds may not be covered by the Financial Services Compensation Scheme. In addition, unlike for trust-based schemes, employer contributions to contract-based schemes do not have to be audited.

19 Where an insurance company or trustee body manages pension fund assets for a group of unrelated employers under a single trust arrangement.

Appendix One

Our audit approach

1 This study examined the effectiveness of the regulation of workplace defined contribution pension schemes. It focused on the work of The Pensions Regulator, whose statutory objectives include protecting the benefits of members of such schemes. The Pensions Regulator shares responsibility for regulating personal work-based (also called contract-based) defined contribution schemes with the Financial Services Authority. The National Audit Office does not audit the work of the Financial Services Authority, but given the shared responsibilities between public bodies, the report also considered wider aspects of the overall regulatory system.

2 Using the Department for Business, Innovation and Skills principles of better regulation we developed and applied our own evaluative criteria to assess value for money, which considers what arrangements would be optimal for delivering effective regulation of workplace defined contribution pension schemes. By 'optimal' we mean the most desirable possible, while acknowledging expressed or implied restrictions or conditions. A constraint in this context is the fact that many factors affect outcomes for pension scheme members and some of those are outside the scope of the regulatory system.

3 Our criteria for good value for money were that:

- The Pensions Regulator has sufficient skills and market information to adopt a risk-based approach to deploying its resources;
- The Pensions Regulator has an effective framework to measure its performance in relation to meeting its statutory objectives;
- the wider regulatory system within which the Pensions Regulator operates is well-integrated, with a common risk framework supported by a strong evidence base, clear accountabilities and responsibilities, and clear ways to intervene to address risks through regulatory action if necessary; and
- there should not be unwarranted variation in outcomes, or in the factors that contribute to those outcomes, for scheme members, given broadly similar contribution levels and investment performance. There should be evidence that regulation is helping to address any unwarranted variation.

4 Our audit approach is summarised in **Figure 15** overleaf. Our evidence base is described in Appendix Two.

Figure 15
Our audit approach

The objective of government

The Department for Work and Pensions, HM Treasury and HM Revenue & Customs all have responsibility for setting the overall policy framework for pensions. The Department for Work and Pensions' policy objectives include promoting good retirement income, improving pension scheme regulation and managing risks.

The Pensions Regulator has statutory objectives which include protecting the benefits of members of work-based defined contribution schemes, and promoting and improving understanding of good administration of work-based pension schemes. It shares responsibility for regulating work-based, contract-based defined contribution schemes with the Financial Services Authority.

How this will be achieved

The Pensions Regulator's activities include collecting information, issuing guidance and codes of practice, and taking enforcement action.

Our study

This study examined the effectiveness of the regulation of work-based defined contribution pension schemes.

Our evaluative criteria

- A risk-based approach to deploying resources.

An effective performance measurement framework.

A well-integrated regulatory system, with a common risk framework supported by a strong evidence base, clear accountabilities and responsibilities, and clear ways to intervene if necessary.

Unwarranted variation in outcomes, or in the factors that contribute to those outcomes for scheme members, is addressed effectively.

Our evidence

(see Appendix Two for detail)

We examined how The Pensions Regulator operates by:
- holding workshops with staff
- reviewing internal documentation
- consulting with experts of various backgrounds and experiences in the pensions industry
- interviewing stakeholders.

We reviewed The Pensions Regulator's activities and performance measurement system by:
- reviewing the regulator's and the Department's aims and objectives
- conducting a file review of published and internal documents
- analysing its data
- interviewing officials.

We assessed the wider regulatory system by:
- mapping regulatory responsibilities
- speaking to officials of regulators and departments involved
- conducting interviews with stakeholders
- conducting a review of existing analyses and literature.

We analysed outcomes for members by:
- undertaking a literature review
- examining external sources of data for trends and variations in member outcomes
- consulting a panel of pension experts
- interviewing a wide range of stakeholders
- analysing The Pensions Regulator's data.

Our conclusions

Our key findings are shown in paragraphs 8 to 19, and our value for money conclusions are shown in paragraphs 20 and 21. The conclusions cover The Pensions Regulator's approach to meeting its statutory objectives relating to the regulation of defined contribution schemes, and its performance, and measurement of performance, against these objectives. Given the sharing of some responsibilities with the Financial Services Authority, the conclusions also cover the objectives, approach, performance measurement and accountability of the wider system for regulating defined contribution schemes.

Appendix Two

Our evidence base

1 Our independent conclusions on whether the regulation of workplace defined contribution pension schemes is effective and delivers value for money were reached following our analysis of evidence collected between October 2011 and June 2012.

2 We applied an analytical framework with evaluative criteria, which considers what arrangements would be optimal for delivering effective regulation of workplace defined contribution pension schemes. Our audit approach is outlined in Appendix One.

3 We assessed whether The Pensions Regulator uses a risk-based approach to deploying resources.

- We held workshops with staff from The Pensions Regulator who are directly involved with the organisation's operational planning. The workshops covered its data gathering and analysis; analysing regulatory activities and influence over the market; The Pensions Regulator's identification, assessment and mitigation of risks arising in the market; and operational planning and resource allocation procedures.
- We reviewed a range of internal documentation, including The Pensions Regulator's risk register, risk and intervention model and market segmentation analysis.
- To develop our understanding of different regulatory approaches used across different industries and provide some specialist opinion on what The Pensions Regulator's approach to regulating the defined contribution pensions market should look like, we included an academic expert on regulation among our panel of experts.
- We undertook over 15 semi-structured interviews with stakeholders, including: private sector pension providers; pensions advisory bodies; consumer protection groups; industry representatives; trade associations; and pensions research organisations. This provided us with a wide range of views on issues in the defined contribution pensions market and on The Pensions Regulator's approach and activity in the market.

4 We examined the effectiveness of The Pensions Regulator's performance measurement framework.

- We reviewed The Pensions Regulator's and the Department's aims and objectives for the regulation of defined contribution pension schemes. We mapped The Pensions Regulator's aims against its regulatory powers and activities with respect to each market participant type. We then reviewed The Pensions Regulator's actions against its own performance indicators.
- We conducted a file review of The Pensions Regulator's published and internal documents, including: annual reports; policy documents; its performance dashboard; and research reports.
- We analysed The Pensions Regulator's performance measurement data. We evaluated performance against its key performance indicators between 2008-09 and 2010-11.
- We held semi-structured interviews with staff from The Pensions Regulator to discuss how it monitors the market, sets performance targets, measures its impact and the difficulties it faces when doing this. We analysed The Pensions Regulator's performance indicators for their breadth of sources and how closely they matched its objectives and activities.

5 We examined the regulatory system against best practice governance and accountability.

- With assistance from The Pensions Regulator and the Financial Services Authority, we mapped their individual responsibilities, alongside those of different market participant types.
- We spoke to officials from both regulators and from the Department to gain an understanding of the operation of the regulatory system on a working level. We reviewed a number of documents which set out the relationship between all the parties involved, including: the Memorandum of Understanding between The Pensions Regulator and the Financial Services Authority; and the terms of reference of the senior level group to discuss defined contribution pensions policy and regulation.
- In our semi-structured interviews with stakeholders we asked for views on the strengths and weaknesses of the current defined contribution schemes regulatory system.
- We drew upon previously published material which considered the shared responsibilities of the two regulators, in particular the National Audit Office's first report on The Pensions Regulator in 2007.[20]

20 Comptroller and Auditor General, *The Pensions Regulator: Progress in establishing its new regulatory approach*, Session 2006-07, HC 1035, National Audit Office, October 2007.

6 We assessed if unwarranted variation in outcomes, or in the factors that contribute to those outcomes, for scheme members is addressed effectively.

- We undertook a literature review to understand how defined contribution schemes operate and to map a customer's journey through the pension scheme life cycle. The review drew upon publications from a wide range of stakeholders and provided an understanding of member experiences and the associated risks in the market.
- We examined external sources of data for trends and variations in member outcomes. The data provided insight into the sources of variation in member outcomes and covered a range of topics which included: the impact of member choice on retirement income; member understanding and use of pensions advice; and charges. We consulted with a number of independent experts to validate and comment upon the data that we collected from this review and used in the report.
- To obtain expert opinions on the variation of member outcomes and to understand specific risks to members in the market we consulted with a panel of experts in pensions and regulation. We consulted with the panel on our provisional audit findings; the panel also advised on the practicality of our recommendations.

  The panel members were:

  - Chris Curry, Pensions Policy Institute;
  - Professor Julia Black, London School of Economics and Political Science;
  - Simon Baynes, Capital Cranfield Trustees;
  - Teresa Sienkiewicz, KPMG; and
  - Tom McPhail, Hargreaves Lansdown.
- We conducted over 15 semi-structured stakeholder discussions to obtain a wide view of opinions on the pensions market and the regulatory regime. We tailored our questions to reflect the key risks that appeared to recur in the literature review and triangulated these themes with the external data analysis.
- To reasonably assess if The Pensions Regulator is effectively addressing unwarranted variation in member outcomes we considered what factors could be practically addressed by regulation. We then analysed The Pensions Regulator's performance measurement data against these factors to measure its progress.

FSC
www.fsc.org
MIX
Paper from
responsible sources
FSC® C001648

Design and Production by
NAO Communications
DP Ref: 009834-001

This report has been printed on Consort 155 and contains material sourced from responsibly managed and sustainable forests certified in accordance with the FSC (Forest Stewardship Council).

The wood pulp is totally recyclable and acid-free. Our printers also have full ISO 14001 environmental accreditation, which ensures that they have effective procedures in place to manage waste and practices that may affect the environment.

National Audit Office

Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail, Telephone, Fax & Email
TSO
PO Box 29, Norwich NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Order through the Parliamentary Hotline
Lo-Call 0845 7 023474
Fax orders: 0870 600 5533
Email: customer.services@tso.co.uk
Textphone: 0870 240 3701

The Parliamentary Bookshop
12 Bridge Street, Parliament Square,
London SW1A 2JX
Telephone orders/General enquiries 020 7219 3890
Fax orders: 020 7219 3866
Email: bookshop@parliament.uk
Internet: www.bookshop.parliament.uk

TSO@Blackwell and other Accredited Agents

£16.00

ISBN 978-0-10-297721-9