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The Pensions Regulator

Regulating defined contribution pension schemes

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.