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Cass Business School
CITY UNIVERSITY LONDON

Pensions Institute

VfM

Assessing value for money in defined contribution default funds

A Pensions Institute report for policymakers, regulators, providers, advisers, employers, and trustees

'Value for money' means the optimum combination of whole-life costs and quality. Finding solutions that achieve the best mix of quality and effectiveness for the least outlay does not always mean choosing the immediately cheapest option… it may be more cost effective to buy a more reliable service or a better quality asset with lower maintenance costs and a longer operating life. National Audit Office

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January 2014

VfM: Assessing value for money in defined contribution default funds

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The Pensions Institute (www.pensions-institute.org) is the first and only UK academic research centre focused on pensions issues. The views expressed in this report are those of the authors and not the Pensions Institute which takes no policy positions.

List of abbreviations

ABI	Association of British Insurers
ALM	Asset-Liability Modelling
AMC	Annual Management Charge
AMD	Active Member Discount
AUM	Assets under Management
BIS	Department for Business, Innovation and Skills
COB	Conduct of Business
CPI	Consumer Price Index
DB	Defined Benefit
DC	Defined Contribution
DGF	Diversified Growth Fund
DMP	Deferred Member Penalty
DWP	Department for Work and Pensions
FCA	Financial Conduct Authority
FSA	Financial Services Authority
GFC	Global Financial Crisis
GPP	Group Personal Pension
GSP	Group Stakeholder Plan
IMA	Investment Management Association
LDI	Liability-driven Investing
MVPO	Mean Variance Portfolio Optimisation
NAO	National Audit Office
NAPF	National Association of Pension Funds
NAV	Net Asset Value
NIC	National Insurance Contributions
OFT	Office of Fair Trading
ONS	Office for National Statistics
PPP	Personal Pension Plan
PRA	Prudential Regulation Authority
RDR	Retail Distribution Review
RR	Replacement Ratio
SME	Small and medium-sized enterprise
TER	Total Expense Ratio
TPR	The Pensions Regulator
VaR	Value-at-Risk

Glossary of Terms

Accumulation: In **DC** this refers to the period of pension contributions and investment, after which the fund is used to provide the lifetime income in retirement (known as **decumulation**).

Active investment: The selection of investments by the manager who aims to outperform an investment benchmark. See **passive investment** and **smart beta**.

Active member: A member of a DC scheme who is working for the sponsoring employer. See also **deferred member**.

Active member discount (AMD): A lower annual management charge that applies to **active members** of a scheme, which is increased when they leave employment. See **deferred member penalty**.

Alternative asset class: A collective term used to describe asset classes that generally are illiquid, such as commodities, hedge funds, infrastructure, private equity, and real estate, among others.

Annual management charge (AMC): The annual management charge, deducted from member funds, covers disclosed investment costs and administration, among other items. The AMC is regarded as an incomplete disclosure measure. The **total expense ratio** is more comprehensive, but is still not complete, nor is **ongoing charges**. There is growing pressure for asset managers to disclose all fund costs such as **transaction costs** and the costs of sub-funds.

Annuity: A lifetime annuity is an insurance policy that guarantees an income for life in return for the DC pension fund (the insurance premium). The purchaser is described as an annuitant. There are also fixed-term annuities.

Annuity rate: The income the insurance company guarantees to pay per month or per annum in return for the lump sum. It can also be expressed as a percentage yield.

Auto-enrolment: The new system of pension scheme provision for all employers, which mainly affects the private sector and which is being phased in between October 2012 and 2018. Employers and qualifying workers (those aged between 22 and the state pension age, earning at least £9,440 in 2013-2014) must make minimum contributions based on **band earnings**, but the latter have the right to opt out. Qualifying auto-enrolment schemes do not have to be DC but, in practice, the majority will be so. They must offer a default fund for members who do not wish to make their own investment decisions.

Band earnings: Under **auto-enrolment**, for qualifying workers the minimum contribution is 8% (comprising 4% from the employee, 3% from the employer, and 1% in tax relief), based on 'band earnings' of £5,668-41,450 in 2013-14. The contribution requirements are being phased in, starting with a minimum of 2% of qualifying earnings, of which the employer must pay a minimum of 1%.

Blended fund: The term used to describe a multi-asset default fund. Most commonly, it is used to denote a fund designed by an **employee benefits consultant** for a large employer's single **trust-based** scheme.

Bundled scheme: A DC scheme where the provider is responsible for both the asset management and administration functions. An alternative description, used by the OFT, is **vertical integration**.

Commission: Until January 2013, many **corporate advisers** that sold pension schemes to employers were remunerated by the provider in the form of sales commission, the cost of which was incorporated into the member's **annual management charge**. They must now charge the employer a fee. See **RDR**.

Contract-based DC: DC schemes can be established under contract or trust law. In a contract-based scheme, the contract is between the member and the provider, for example a life office. Contract-based DC is regulated by the Financial Conduct Authority (FCA). See also **trust-based DC**.

Consultancy charge: Initially this replaced sales commission following the **RDR**, but the government banned the charge shortly after it was introduced, as it was concerned that the deduction of the charge from member contributions would undermine auto-enrolment, especially for lower earners and frequent job changers.

Core asset class: A 'core' asset in a default fund denotes an asset class that represents a single and significant component of the fund. See also **alternative asset class**.

Corporate adviser: The distinction between **employee benefits consultants** and corporate advisers is blurred. Historically it denoted the remuneration basis (fees or commission respectively), but it also denotes the target market, which, for corporate advisers, tends to be the **SME**.

Decumulation: The process whereby the DC fund built up during the **accumulation** stage is converted into a lifetime income in retirement. Typically this involves the purchase of a lifetime **annuity**, but the member might also draw directly from the fund (**income drawdown**).

Default fund: In a DC scheme this is the multi-asset fund designated to receive the contributions of members who do not make an investment choice. Under **auto-enrolment**, an estimated 90-97% of members will rely on this fund.

Deferred member: The description applied to members of DC schemes who leave the sponsoring employer's company. In a **trust-based** scheme, membership continues and so former employees continue to be the responsibility of the scheme trustees. In a **contract-based** scheme, the contract would usually be reclassified as an individual personal pension, so the individual is no longer a member of the previous employer's scheme.

Deferred member penalty (DMP): An increased annual management charge applied when a member leaves a scheme where an **active member discount** is used.

Defined ambition (DA): A DWP initiative that aims to encourage employers to provide DC schemes that offer more predictable outcomes, for example via some form of return guarantee or risk-sharing mechanism between different cohorts of members.

Defined benefit (DB): Members' pensions are linked to salary (e.g., final salary or now more commonly earnings averaged over the period of membership). The sponsoring employer is ultimately responsible for meeting the liability if the scheme is underfunded. See **defined contribution**.

Defined contribution (DC): In DC, the member's pension is based mainly on the level of contributions invested, the charges deducted, and investment returns. The fund is used at retirement to generate a lifetime income, usually in the form of an **annuity**. Therefore the investment and longevity risks, among others, fall solely on the individual members.

Diversified beta: see **smart beta**.

Diversified growth fund (DGF): A fund that aims to increase the return and/or reduce risk through investing in a wide range of asset classes, usually including **alternative asset classes**.

Employee benefit consultant (EBC): The distinction between EBCs and **corporate advisers** is historic and generally denoted the remuneration basis. EBCs generally target the larger employers (DB and DC) and trustees. They might also act as a **fiduciary manager** if they have launched their own DC scheme.

Fiduciary manager: With reference to DC schemes, this is where an asset manager or **EBC** offers a full asset management service for the default fund, drawing on third-party asset manager funds (and sometimes their own funds) for each asset class. The role is broadly equivalent to that of a chief investment officer. Where an EBC offers its own scheme, it would manage the administration (in-house or, more likely, via third-party arrangements, including life office platforms).

Glide path: In a default fund, members' funds are transitioned over a period of years before retirement (e.g. 10-15) from risky assets into bonds and cash, for example, in order to protect them from market shocks before **decumulation** and the purchase of an **annuity**.

Group personal pension scheme (GPPS): A **contract-based** workplace pension scheme. In effect a grouping of individual **personal pension plans** but with pricing to reflect the group nature of the arrangement.

Income drawdown: At retirement, instead of purchasing an **annuity**, the member draws a regular income directly from the fund. The maximum amount that can be drawn is linked to the prevailing **annuity rate**.

Index tracking: See **passive management**.

Investible frontier: The practical risk-return tradeoff frontier for investors. It is not strictly the same as the efficient frontier. Along the efficient frontier, investors can only increase their expected return by assuming more investment risk and vice versa. The true efficient frontier is likely to be further out in risk-return space than the investible frontier. Nevertheless, for all practical purposes we can think of the investible frontier as being approximately the same as the efficient frontier.

Life fund: The generic term to describe collective or pooled funds sold by the life office and asset management arms of insurance companies.

Lifestyle/lifecycle: Another term to describe the **glide path** of a default fund. Here the strategic decisions are made by the scheme fiduciaries and their advisers. Although it appears to be a single fund, the glide path usually uses different risk-graded funds for the main growth phase and the de-risking phase. See **target date fund**.

Long-only strategies: Investment strategies that only involve the purchase of securities (i.e., no **short selling**)

Long-short strategies: Investment strategies that involve the purchase of some securities (those that are believed to be under-priced) and the **short selling** of other securities (those that are believed to be overpriced)

Master trust: A **trust-based** DC workplace pension scheme that can accommodate multiple non-related employers. The trustee board might be wholly independent of the scheme provider or might include provider representation.

Micro employer: In the context of auto-enrolment, an employer with fewer than 50 employees. See **SME**.

Middleware: One of the terms used to describe IT systems that integrate the employers' payroll system with the auto-enrolment duties to enrol employees and to pay the correct level of contributions.

Ongoing charges: A disclosure method for fund costs and charges recommended by the IMA for UK authorised funds.

Passive investment: Also known as index-tracking, here the manager purchases all the stocks or a representative selection of stocks in the relevant index according to standard market capitalisation weightings. See **active investment** and **smart beta**.

Personal pension plan (PPP): An individual (retail) DC pension plan, introduced in 1988.

Platform: With reference to DC schemes, this is the life office IT 'engine', which manages the day-to-day running of a range of functions including asset management, administration (e.g., of contributions), and compliance. It might also include member communication and documentation, or this might be part of the **middleware**.

Replacement ratio (RR): The member's income replacement ratio (RR) is the ratio of the pension in the first year of retirement to the final salary before retirement

Retail Distribution Review (RDR): The RDR came into effect on 1 January 2013. It banned adviser **commission** for new sales of investment products, including pension schemes and plans. From this date onwards, all advice relating to the sale of new investment products must be fee-based.

Self-select funds: The term used to describe the range of funds in which members of a DC scheme can invest if they want to make their own decisions, as opposed to using the **default** fund. Not all schemes offer self-select funds.

Sharpe ratio: This measures risk-adjusted performance. The ratio is calculated by subtracting the risk-free rate (e.g. Treasury bill rate), from the rate of return for a portfolio and then dividing the result by the standard deviation of the portfolio returns.

Smart beta: A form of enhanced **passive investment** where the asset manager deviates from the standard market capitalisation weightings in the relevant index. Typically this involves reducing the weighting in what are considered overvalued stocks and increasing the weighting in undervalued stocks, where the valuation of stocks is typically based on 'fundamental' factors, such as P/E ratios and dividend yields. A variation is **diversified beta** which looks for the fundamental drivers of returns across a wider range of asset classes than just stocks.

SME: Small and medium-sized enterprise. For auto-enrolment purposes, the term can be used to describe employers with 50-250 employees, but in more general use it can mean anything up to 500 employees. See **micro employer**. It is relevant that of the 1.3m employers required to implement auto-enrolment, almost 1m have fewer than 10 employees.

Staging date: This is the date at which employers' new duties under **auto-enrolment** become obligatory. The date depends on the size of the employer's pay-as-you-earn (PAYE) scheme. It began with the largest employers in October 2012 (120,000+ employees in the PAYE scheme) and concludes in 2017-18 with the smallest.

Stakeholder pension scheme: Introduced in 2001, stakeholder schemes are like **group personal pension schemes**, but must meet certain requirements in relation to accessibility and fair terms and conditions.

Target date fund (TDF): An investment strategy designed for DC **default funds**, whereby the scheme establishes a range of TDFs, each with its own **glide path**. This might involve a TDF for each possible retirement date, or there might be a single TDF for members who plan (or are expected) to retire within a given five-year window, for example. So, a 40-year-old joining in 2013 might be put into the 2038 TDF if he or she is expected to retire at age 65. See **lifestyle**.

Total expense ratio (TER): The TER is a more comprehensive measure of the member's total annual cost than the **annual management charge** (AMC), but is still not complete. It includes the AMC and fees for a range of services including legal, administration, audit, marketing, directors, and regulatory costs. There is growing pressure on schemes to reveal all fund costs, including **transaction costs** and the cost of sub-funds.

Transaction costs: Costs that are incurred as a consequence of dealing in assets. These include bid-offer spreads, transaction costs of underlying (sub) funds, profits from stock lending retained by fund managers, interest on cash balances retained by fund managers, and FX spreads on currency hedging, among others.

Trust-based DC: Schemes set up under trust law where the trustees are the legal owners of the assets on behalf of members and have a fiduciary duty to act in members' best interests. These schemes are regulated by The Pensions Regulator (TPR).

Value-at-Risk (VaR): A downside measure of the level of financial risk within a fund over a specific time frame. The risk manager aims to ensure that risks are not taken beyond the level at which the firm can absorb losses equal to the VaR.

Vertical integration: Also known as **bundled**, this term describes schemes where the provider runs the asset management and administration.

Foreword

Auto-enrolment is the new workplace system for pension scheme provision for all employers, although its main impact will be felt in the private sector. It is being phased in by employers between October 2012 and 2018. The most important feature of auto-enrolment schemes is the default fund, which is the multi-asset investment strategy designed for the majority of members who do not wish to make investment decisions. Total contributions, member charges, together with the fund's full costs, the asset allocation, and the glide path (the changing asset allocation over the period of membership) are key determinants of the level of the pension income in retirement that is secured by the fund at the decumulation stage, which, at present, usually involves the purchase of a lifetime annuity.

In October 2012, the Pensions Institute published *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware*.[1] The report analysed the DC default funds used for auto-enrolment from two main perspectives. The first was qualitative: the impact on member outcomes of the behaviour of *buyers* (employers and trustees on behalf of members) and sellers (the providers and advisers). The second was quantitative: the application of stochastic simulation methods to identify the likely range of possible member outcomes based on an appropriately calibrated pension simulation model.

In this new report we ask whether the cost of membership (we use the total expense ratio or TER) offers value for money to the 'average' member, by which we mean the 90-97% of employees who will be automatically enrolled into the default fund. To answer this question, we build on the preliminary quantitative and qualitative findings of *Caveat Venditor*, which are summarised in Appendix 1, and provide fresh analysis of the rapidly-evolving supply chain, which determines the employer's choice of auto-enrolment scheme and the TER. Conventional wisdom in the DC market suggests that you get what you pay for: that higher charges are rewarded in the form of a better member outcome. In the context of auto-enrolment, the research finds that this is not the case.[2]

The new quantitative work presents in full the results of a unique modelling exercise that investigated the after-charge investment performance of a representative sample of contract- and trust-based default funds sold between 1990 and 2013.[3] We express performance outcomes in terms of the income replacement ratio (RR), by which we mean the ratio of the pension in the first year of retirement to the final salary before retirement that could be achieved by participating in each fund over different investment horizons.

'Value for money' (VfM) does not necessarily mean 'cheapest', as the National Audit Office (NAO) explains in the quotation on the front cover of this report.[4]

1 www.pensions-institute.org/reports/caveatvenditor.pdf

2 For evidence of this in the context of UK pension fund investment, see, e.g., Blake, D, Lehmann, B, and Timmermann, A. (1999) 'Asset Allocation Dynamics and Pension Fund Performance', Journal of Business, 72, 429-61.

3 We have not modelled ethical and Sharia default funds, but suggest if membership levels prove to be significant, this would be a valuable exercise, given the significant asset allocation restrictions Sharia funds in particular face.

4 See http://www.nao.org.uk/intelligent-monitoring/intelligent-monitoring/about-monitoring/why-monitor/

Therefore our qualitative analysis examines VfM in relation to the objectives of the component parts of the supply chain and asks how well scheme providers' business models are aligned with the requirements of the buyers of the schemes (the employers), the sellers of schemes (the advisers) and the real customer – the scheme members who have no say in the employer's choice of scheme or its cost. The key features of a scheme's VfM are the design and cost of the default asset allocation strategy, plus scheme costs, such as administration, marketing and communication. In most cases, the stated cost of asset management is not the biggest component of the total expense ratio (TER). However, it is not always clear what other component costs cover and whether these should be paid for by the member. In some cases, the member charge increases when a member leaves the scheme or transfers their pot to another scheme. Good governance requires VfM to be maximised, while recognising that 'cheapest' does not always mean 'best' and that the quality of services such as administration is as important as their cost. Good governance also requires the regular assessment of how the scheme is delivering VfM.

We believe that the present report, through its integrated qualitative and quantitative analysis of the supply chain, the cost of membership (TER), the investment strategy, and scheme governance will inform the debate about what constitutes a 'good' DC scheme. While we agree that the level of contribution is a key determinant of the member outcomes, and that the 8% of band earnings being phased in is not sufficient, we argue that the minimum contribution level should not be increased above that level until the government is confident that qualifying schemes represent good value for money for members.

Our research began in November 2012, immediately after the publication of *Caveat Venditor*, and concluded in December 2013. We would like to thank the many organisations that helped with this research. Those that were happy to be named are listed in the acknowledgements. Where we quote from a published report, the source is cited. Where we quote from interviews, the comments are anonymised. This technique, pioneered by the Pensions Institute for its practitioner reports, enables us to express the views of stakeholders more candidly than might otherwise be the case.

We would particularly like to thank the four sponsors of the research: B&CE's The People's Pension, Hymans Robertson, NEST, and NOW: Pensions. The views expressed in this report are those of the authors, not necessarily those of the sponsors, which did not seek to influence the research, or the Pensions Institute, which takes no policy positions. It is important to note that the individual schemes cannot be identified in the quantitative modelling results due to a randomisation of the scheme labels, and that in the interests of scientific integrity, even the sponsors were given no information that would enable them to identify the performance of their own schemes.

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January 2014

Findings

1. We predict that the DC workplace scheme market will increase more than six-fold by 2030, from £276bn assets under management (AUM) pre-auto-enrolment (2012) to about £1.7trn.

2. We expect five or six trust-based multi-employer schemes to dominate the market by 2020. The associated rapid consolidation among providers could lead to market instability. There is already evidence of providers withdrawing from sections of the market they originally planned to serve.

3. Single employer schemes are likely to transfer to multi-employer arrangements once employers have removed their defined benefit liabilities from the balance sheet, at which point they will be able to dismantle their DB trustee infrastructure.

4. The practice of 'cherry-picking', whereby providers take on only the profitable section of a workforce, is undermining employers' trust in providers. It can force SMEs that have an existing provider either to run two schemes or to switch to a new provider just before their staging date.

5. A re-evaluation of contract law is urgently required to facilitate the mass migration of member assets from old to new schemes to ensure value for money for the full accumulation period.

6. Former commission-based corporate advisers face an uncertain future. From mid-2014, 'disintermediation' will be the hallmark of scheme distribution, with employers increasingly seeking solutions from the major master trusts. SMEs with no pre-existing scheme are likely to tackle compliance mainly through payroll (rather than pension) solutions.

   The withdrawal of formerly-commission-based advisers that cannot operate profitably on a fee basis puts multi-employer schemes under increased pressure to provide employers with compliance software to meet auto-enrolment duties. However, payroll software providers are also offering partial or full auto-enrolment compliance solutions.

7. The meaning of member value for money (VfM) is distorted by supply-side imperatives that are poorly-aligned with members' interests. From 2014, many providers will prioritise their services:

   - First, to the corporate adviser (formerly commission-based, now fee-based), which sells schemes to employers and whose advice in this market is unregulated
   - Second, to the employer, which acts as the provider's unregulated agent
   - Third, to the member, who pays for the scheme, but has no choice in the design or charges

   Our research found cases where providers provided services both to advisers who helped bring in business and to employers free of charge, but then covered the cost of those services via the member charge, raising the question whether this was fair to members.

8. The total expense ratio (TER) is a key determinant of the default fund's outcome, which we express as an income replacement ratio (RR) in retirement. Of the funds modelled, the default fund with highest mean RR (23.8%) was 55% higher than that with the lowest mean RR (15.3%). This was largely due to charge differences. As a rough rule of thumb, each percentage point increase in the TER leads to a fall in the expected replacement ratio at retirement of about 20%, and to a somewhat smaller fall in the lower bound of the projected retirement replacement ratio.

9. While the investment strategy has an important impact on member outcomes, it is much less important than the impact of charges.

10. There is a notable trade-off between risk and return, but it is only the low-charge schemes that lie along the investible frontier. In other words, while 'cheapest' is not synonymous with 'best', there is no evidence that higher charges can 'buy' more sophisticated investment strategies that deliver superior performance.

11. Two types of fund tend to deliver above-average outcomes relative to contributions paid: single trust-based schemes, designed by fee-based consultants for large employers; and modern trust-based multi-employer schemes.

12. Individuals in high charging schemes could benefit considerably from switching to low charging schemes, unless 'exit penalties' are prohibitive.

13. Longer investment horizons generally deliver better average outcomes with lower risk. Roughly speaking, doubling the length of the investment period (e.g., from 5 to 10, then from 10 to 20 years, etc.) approximately doubles the mean replacement ratio. The lower bound grows at only the square root of the length of the investment period, approximately. In other words, VfM increases the longer the member remains invested (so long as charges are competitive).

Recommendations

1. A clear definition of member VfM

Value for money (VfM) for members means the optimal combination of scheme cost and design, sustainable over the accumulation and decumulation periods. This includes:

- A TER in the region of 0.5% a year for the accumulation period (at current levels of scale)
- A well-designed multi-asset default fund with a glide path that is subject to regular modelling scrutiny in relation to the member income replacement ratio (RR) and the downside risks.
- Expert independent governance fully aligned with all members' interests, including both active and deferred, through accumulation into decumulation. Governance requires the expertise to assess VfM in relation to design and charges and should have demonstrable power to manage all conflicts in the members' best interests.
- Effective member communications that focus on improving the outcome, e.g., paying higher contributions, working longer, and/or delaying the annuity purchase date.
- An efficient consolidation system that helps members to transfer older DC pots to the new scheme, where these are held in poorly diversified funds with higher charges.
- A decumulation service that is part of the scheme and provided by a specialist retirement-income adviser that adheres to robust service standards.

2. A clear definition of the member's target outcome in terms of an income replacement ratio

The only meaningful expression of the member outcome is the income replacement ratio (RR). It is currently common to express member outcome in terms of fund size; but, fund size is a poor measure of member outcome, since it does not take account of the annuity-conversion risks, which include interest rate volatility and longevity risk.

However, it does not necessarily make sense to target RR or fund size as part of the default fund's investment strategy. It is important to avoid over-engineering the default fund's investment strategy which should have a straightforward target, such as CPI (consumer price index) + X%. Any targeting of outcomes (ideally in terms of RR) needs to be conducted through the scheme's funding strategy. This might require additional employer and/or employee contributions if there is a shortfall in the target.

3. A clear definition of costs and charges, reported in full

All costs extracted by the default fund and the scheme should be reported in full to governance boards and to regulators, so that component parts of the member charge, as well as the total, can be evaluated in relation to member VfM. Full disclosure data should also be made available on a central website for independent public scrutiny.

4. Assets in older sub-standard schemes to migrate to new schemes

A thorough review of, and a revision to contract law in relation to DC pensions should enable the government and regulators to prompt an evaluation and mass migration of assets from older schemes (pre-2013) – many of which are characterised by sub-optimal asset management, as well as higher charges, including adviser commission – to modern schemes or to one or more modern aggregators (to be designated). This process should include all personal pension plans created when members of contract-based schemes leave employment. The OFT-instigated audit of charges in pre-2001 contract-based schemes should apply to all schemes sold before January 2013 and should be undertaken by the regulators, not by a 'committee' dominated by the providers that sold the schemes in the first place.

5. The need for regulatory reform

The current dual system of regulation whereby The Pensions Regulator regulates trust-based schemes and the Financial Conduct Authority regulates contract-based schemes should be reformed.

Section 1: Value for money and the supply chain

In this section, we examine the meaning of value for money (VfM) and consider the implications of supply-side imperatives for members, who are at the end of the supply chain. In the following section, we examine two key quantifiable components of value for money in a representative range of default funds currently available in the UK – namely, charges and investment strategy – and model their impact on potential pension outcomes for scheme members who rely on the default fund.

1.1 Auto-enrolment: a game changer for providers and advisers

The Pensions Acts of 2007 and 2008 imposed new legal duties on all employers, the main burden of which will fall on private sector employers.[5] Starting with the largest employers in October 2012, and ending with the smallest in 2018, the auto-enrolment legislation requires employers to enrol qualifying workers (those earning at least £9,440 in 2013-2014) between age 22 and the state pension age into a 'designated' pension scheme, which must include a default fund for members who do not wish to make investment decisions. The policy objective of auto-enrolment is to ensure employees build up adequate private pensions, which will reduce the financial burden of the retired population on the state and, therefore, on the tax-payer.

The date at which the new duties take effect (the 'staging date') depends on the size of the employer's pay-as-you-earn (PAYE) scheme.[6] The first staging date in October 2012 applied to employers with 120,000+ employees in the PAYE scheme; the final staging dates in 2017 and 2018 apply to employers with fewer than 30 employees.[7] More than 30,000 employers with workforces of 50–250+ will have received notice of their staging date by April 2014. We define this category as small and medium enterprises (SMEs) for the purpose of this report. Micro employers (defined in this report as those with fewer than 50 employees) will start to receive their staging date notification later in the year. Numerically, SMEs and micro employers account for the vast majority of employers.

There was a consensus among all interviewees for this research that compliance with initial auto-enrolment will be a burden for SMEs and micro employers. In most cases, they will need help in assessing employees in relation to their contract of employment and to earnings, which might fluctuate month-by-month. However, there was considerable disagreement as to whether the best source of employer support should be the scheme provider, the payroll software provider, an off-the-shelf pension/payroll software provider, or an adviser. The choice is made more complicated by the fact that the smaller employers are least likely to be prepared to pay for advice, particularly if they have no existing pension provision on which to build.

For qualifying workers, the minimum contribution rate is 8% (comprising 4% from the employee, 3% from the employer, and 1% in tax relief), based on 'band

5 Most, but not all public sector schemes already use auto-enrolment.

6 www.thepensionsregulator.gov.uk/employers/staging-date-timeline.aspx

7 The confirmed schedule applies to employers who will reach their staging date by 2015, when the General Election will be held. However, there is a provisional schedule for post-election employers.

earnings' of £5,668-£41,450 in 2013-14. Employer and employee contribution rates are being phased in, which means that the full 8% will not be compulsory until 2017-18. Employers can choose to set higher minimum contribution rates, but while this practice is common among some of the larger employers, many SMEs and micro employers are expected to meet the minimum requirement only. It is widely recognised – and acknowledged by the government – that 8% of band earnings will not deliver adequate pensions, even when combined with the simplified state pension set above the level of means tested benefits being introduced in April 2016.[8] Many of the people we interviewed expect the government to increase the minimum contribution rate requirement shortly after auto-enrolment is fully implemented.

Under auto-enrolment, employees have the right to opt out, but, if they do so, employers must re-enrol them every three years. This is the feature that distinguishes auto-enrolment from full compulsion – where opt-outs are not permitted – which is the system used in Australia[9], the Asia-Pacific region, Eastern and Central Europe, and in Central and South American countries.

The success of auto-enrolment, therefore, is predicated on the behavioural trait of inertia, namely, that once in, members will stay put.[10] This is the first game changer – it is no longer necessary to 'sell' the benefits of scheme membership to *employees*.[11] The second game changer is equally significant. It is no longer necessary to sell the benefits of pension schemes to *employers*, because they must have a designated scheme in order to fulfil their legal duties. Accordingly, this is a compulsory purchase on the part of employers. In most cases, they can choose the provider, but providers have the right to turn them down; the exception being NEST, which has a public service obligation to accept any employer and a number of providers have now entered the market and are providing pensions to all employers (e.g., B&CE's The People's Pension).

These game changers affect the supply chain in ways that are already evident and in ways which have yet to be fully understood. In particular, auto-enrolment disrupts the traditional role of providers and advisers as 'manufacturers' and 'sellers' of schemes respectively. The market will experience considerable upheaval between now and 2020, a period we predict will be characterised by rapid consolidation, with the number of large-scale multi-employer schemes reducing to five or six. Consolidation among providers will take the form of mergers and acquisitions and also sales of DC pension scheme books, which might go to consolidators that are uncompetitive because they do not sell new schemes. We also expect the adviser market to contract, both at EBC and corporate adviser level.

Providers and advisers are well aware that auto-enrolment is a one-off opportunity to win sufficient market share to survive in their current form. The stakes are high.

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8 See, for example, Pensions Policy Institute, 'What Level of Pension Contribution is Needed to Obtain an Adequate Retirement Income?', October 2013, https://www.pensionspolicyinstitute.org.uk/uploadeddocuments/20131022_AE_Adequacy_FINAL_REPORT.pdf

9 In Australia, where full compulsion was introduced in the early 1990s, the modern 'Super' scheme is a trust-based, not-for-profit multi-employer arrangement that appears to have very strong governance.

10 Opt-out rates for the largest employers – the first to implement auto-enrolment – are in the region of 8-15%.

11 In a voluntary market, most pensions are sold not bought.

We predict the DC workplace scheme market will increase more than six-fold by 2030, from £276bn AUM pre-auto-enrolment (2012) to about £1.7trn.[12] Competition is fierce, with concerns already emerging about predatory pricing, 'vertical integration' (where providers also act as in-house asset managers), the increasing number of tied arrangements between providers and 'independent' advisers, and the entrance of EBCs as scheme providers in their own right.

1.2 2013: A year of consultation on competition and VfM

Following the publication of *Caveat Venditor* in October 2012, which drew attention to the pernicious impact of high charges on member outcomes, in January 2013, the OFT began its investigation into competition in the DC scheme market. Its report, published in September 2013, described a market where the buy side was characterised by a low level of knowledge and understanding (the main drivers for competition) and a high level of complacency on the supply side.[13] Among other findings, the OFT identified £40bn of assets in high-charging pre-2001 schemes representing 1.4m members, which the industry has agreed to investigate. It also found that active member discounts (AMDs), which confer lower charges on active members, but higher charges on leavers (via deferred member penalties or DMPs), were evident in 10,000 schemes, representing £13.4bn AUM.

The OFT concluded that 'competition cannot be relied upon to ensure value for money for savers in the DC workplace pensions market'. The blame in part, it said, lay in poor governance, particularly in contract-based schemes, where the interests of decision-makers are not well-aligned with the interests of members, and where the absence of a single decision-maker with ultimate responsibility for member outcomes 'creates scope for misaligned incentives'.[14] In response to the OFT report, in October 2013, the DWP published its long-awaited consultation on a member charge cap, while throughout that year the DWP was consulting on the ways in which quality can be demonstrated by DC schemes.[15]

A very timely new entrant to the debate was the Law Commission, which published a consultation paper in October 2013 that examined the ways in which fiduciary duties apply to investment intermediaries, including investment consultants, asset managers and custodians.[16] One of the Commission's

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12 Source: The Pensions Institute. The main assumptions underlying this projection are auto-enrolment minimum contribution rates of 8% of salary p.a., salary growth of 5% p.a., nominal investment returns of 6% p.a., and CPI inflation of 3% p.a. Personal pensions are excluded from this estimate.

13 http://www.oft.gov.uk/shared_oft/market-studies/oft1505

14 The OFT found similar knowledge gaps in the trustee boards of small trust-based schemes. However, here at least there is a governance framework that can be improved in terms of skills and knowledge, because under law and regulation trustees' interests should be wholly aligned with the members'.

15 Quality Standards in Workplace Defined Contribution Schemes, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210700/quality-standards-workplace-defined-contribution-pension-schemes.pdf; Better Workplace Pensions: A Consultation on Charges, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254332/cm8737-pension-charges.pdf

16 Fiduciary Duties of Investment Intermediaries, October 2013, http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm. The project follows from the Kay Review on UK Equity Markets and Long Term Decision Making, July 2012, http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm. The report revealed a complicated supply chain with a reported 13 levels of intermediation.

proposals is to regulate advice to employers – a recommendation we made in *Caveat Venditor*. The reason for the present anomaly is that the FCA (and previously the FSA) appears to regard all employers, irrespective of size, as institutional purchasers. Yet, as earlier reports from the DWP[17] and the September 2013 OFT report make very clear, many SMEs and micro employers know as much about pension schemes as the average employee, i.e., little or nothing.[18]

The Law Commission's consultation raised concerns about the potential conflicts of interests in master trusts where the provider is the asset manager and is able to influence the trustee board directly or indirectly. This point was also stressed by the OFT and is high on the agenda for TPR analysis. The Law Commission said:

> *Some master trusts schemes may suffer from conflicts of interest. Trustees who are appointed and paid by the pension provider may not be able to challenge the provider's actions. In particular, trustees may not be able to change investment managers when in-house funds are under-performing.*

The Law Commission pointed to the dual regulatory structure as problematic, since it allows for 'regulator shopping' or what is more commonly known as regulatory arbitrage. Major providers have taken advantage of this 'facility', but it is also being used by dozens of very small master trusts. TPR estimates that there are 70 master trusts in existence. It has expressed concerns about conflicts of interest and also the low entry barriers when compared with the requirements under the FCA to set up a new insurance company.

The Law Commission's main focus was the opaque world of investment intermediaries, which, the Commission said, might engage in short-term churning of assets to further their own financial objectives rather than those of investors – a point that echoes the concerns raised in *Caveat Venditor* and the OFT report about misaligned incentives in the supply chain. The Law Commission did not say that each party in the asset management value chain had to take specific responsibility for member outcomes, but that there needs to be an identifiable fiduciary that acts for member interests. The analysis considered the legal distinctions between contract- and trust-based schemes and found that for the former, in the absence of trustees, 'the law is much less certain'. It said that there were 'no clear legal duties on [contract-based] pension providers to act in the best interests of their members or to reassess the suitability of investment strategies over time'.

It concluded that the law cannot resolve all of these problems and that robust regulation is crucial:

> *In the case of workplace DC pension schemes, we think legal duties are insufficient on their own to ensure good outcomes for members … regulation must take the lead in protecting pension scheme members' interests. Judge-made laws, such as fiduciary duties, cannot make up for gaps in regulation.*

No doubt the Law Commission will examine contract-based schemes in relation to the Unfair Terms in Consumer Contracts Regulations (UCCTR, 1999) and

17 DWP, Pension Landscape and Charging, 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf

18 The implication of this is that the FCA's Conduct of Business regulatory regime does not appear to be fit for purpose when the customer is not the end beneficiary.

the Unfair Contract Terms Act (UCTA, 1977), which are in the process of being consolidated and clarified in new legislation, the Consumer Bill of Rights.[19] The new law aims to address, among other issues, the 'risk of detriment to consumers accepting unclear contract terms which turn out to be unfair'. Employees who joined employer schemes under the voluntary system were unlikely to have read and understood their contract terms: they simply joined 'the company pension scheme'. Nevertheless, they are treated as though they have explicitly consented to these terms and their consent is further required to transfer funds to a modern default fund in a lower-charging scheme. Under auto-enrolment, contract-based arrangements appear to be even less satisfactory, as employees are enrolled without their explicit consent, so there is only an assumed contract.

Under UCCTR, 'unfair' is defined as follows:

- if a contract has not been individually negotiated, and
- the term causes a significant imbalance in the parties' rights and obligations, then
- the term is contrary to the requirement of good faith.

Regulation 8 provides that an unfair term 'shall not be binding upon the consumer'. It is to be hoped that a re-evaluation of older contracts would make it easy for members of schemes with higher charges to transfer assets to their new schemes or to an aggregator – preferably via a guided process that automatically checked old contract terms. This process should also deal with schemes that, by modern standards, have an inappropriate investment strategy (e.g, they have no de-risking glide path).

The two features – charges and investment – are closely connected. Ten years ago, in 2004, the Pensions Institute published *Delivering DC: Barriers to Participation in the Company-Sponsored Pensions Market*, which said that schemes sold by commission-based advisers to SMEs frequently were selected on the basis of the commission level, rather than on the quality of the default fund.[20] To be fair to advisers, at this time the default funds of the life offices looked very similar if not identical, while asset management was almost always an in-house function. These funds were described as 'actively managed' and 'balanced', but a closer look revealed funds that many were closet trackers, typically 80% in equities, which suggests that the fund managers who charged active fees were being overpaid. The asset allocation was 'static' and in some cases did not include a de-risking period in the glide path in the run up to retirement. Where the fund did de-risk, typically this was over three or five years. For a member of such a fund, who retired in 2013, a de-risking period of five years would have started in 2008 (2010 for a three-year de-risking period). The fund value would have plummeted in 2008, just as the move out of equities began. The fund would have switched into bonds that were very expensive to buy as a result of the quantitative easing strategy adopted by the Bank of England in response to the Global Financial Crisis (GFC). As a result, the fund value in

19 The Unfair Contract Terms Act (1977, UCTA), http://www.legislation.gov.uk/ukpga/1977/50; The Unfair Terms in Consumer Contracts Regulations (1999), http://www.legislation.gov.uk/uksi/1999/2083/pdfs/uksi_19992083_en.pdf; The Consumer Bill of Rights: Proposals on Unfair Contract Terms, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206437/bis-13-909-consumer-rights-bill-proposals-on-unfair-contract-terms-impact.pdf

20 http://www.pensions-institute.org/reports/deliveringDC.pdf

2013 would have been much lower than before the GFC. To make matters even worse, the member would be buying an annuity to provide the pension at a time when annuity rates were at an all-time low. We believe that expert independent governance and good scheme design would have helped to mitigate these unfortunate member impacts.

1.3 What are the member charges?

The subject of charges and their disclosure is contentious, not least because disclosure is targeted at members in contract-based schemes, as it would be for any retail product, even though the member cannot be expected to understand the charges and their impact, and has no say in the choice of scheme or its costs.

> *The member is the least able party to the scheme to understand the charges. Smaller employers and trustees of smaller schemes are no better in my experience. The government has asked 'who needs this information' [charges disclosure]? The answer is 'those who can reasonably act upon this information', but it's not necessarily clear who these experts are.* EBC

Disclosure is a complex subject and relates to both the fund costs and the cost of scheme membership – i.e., the 'product' or package costs – which include many other component parts, such as member account administration. There has been resistance in certain parts of the market to full disclosure at fund level. It has been argued that full disclosure is technically impracticable.[21] It has also been argued if members knew the full cost of scheme membership, they would either opt out or choose a cash fund over the main default fund, as the costs would appear lower.

We do not find such arguments persuasive. We would argue that the principle of full transparency is paramount and that there is little point in comparing charges or in setting a charge cap where the measure used for charges is seriously incomplete.

> *Schemes and asset managers are boasting that they are so low cost they can't make a profit. This is nonsense – all that low charges tell us is that the real asset management costs are going out of the funds before the member charge is extracted.* Independent consultant

> *A charge cap on an incomplete disclosure measure would not just be pointless, it would actively encourage greater opacity at fund level and drive bad practice in the asset management community.* EBC

> *If all charges earned are not included in the charges cap, it is easy to see fund managers using alternative sources of revenue [e.g. soft commissions], as well as stock-lending, to replace the fees lost from a reducing AMC. It will be hard for fiduciaries to either see this going on or do much about it. We should not underestimate the ingenuity of the financial services industry. Any opportunity for a loophole will be taken so it is important that a 'cover-all' clause is inserted in legislation that addresses both the spirit as well as the specifics of the legislation.* EBC

21 The IMA draft Statement of Recommended Practice (SORP) proposes that fund managers should declare the following transaction costs: transfer taxes, commission (execution), commission (research), and, amounts recovered on units issued and cancelled. However, it does not suggest publication of the following transaction costs: the transaction costs incurred by underlying funds; the profits made by funds when stock-lending is undertaken; and interest retained by fund managers on cash balances. It makes it optional to declare the average portfolio dealing spread and does not suggest publication of the portfolio turnover rate. See http://www.investinginfunds.org/assets/20120628_EnhancedChargesDisclosureGuidance.pdf

Full and consistent disclosure, we argue, is simply good practice, but 'to whom?' is a separate and important question. Disclosure is only effective if the receiving party can act on the information and can understand what might appear to be anomalies.[22] Clearly, a detailed analysis of charges is not a job for members or, indeed, for most SMEs, which are unlikely to have the time and necessary skill set.[23] Instead, we argue that the analysis should be the responsibility of those with a fiduciary duty to act in the members' interests, i.e., the trustees or governance board, which need to know what questions to ask and how to evaluate the information received. However, the skill set of such boards also varies and therefore we recommend that regulators should undertake the responsibility for ensuring disclosure is complete and presented in a usable format. We also recommend that all disclosure is made available via a central web-site, so that any party with an interest can examine the data. Effective governance at scheme and regulatory level, as described, should ensure that such disclosure is used to improve competition and to benefit members.

> *The detailed breakdown of these costs is likely to be of no interest to anyone outside of a small coterie of experts. However, the cumulative impact of total billing is of interest to everyone and a single number demonstrating total costs for each provider is useful to employers and to the more interested employee.* Actuary

> *Most [active] funds over-trade. There should be a fee structure that dissuades fund managers from trading unnecessarily. Where I am really uncertain is in the murky world of broking. We never get involved with that side of the industry. Are they [brokers] any good? Are their fees sensible or reasonable? Is competition effective in that area? Why do fund managers bother taking their research – shouldn't they be doing their own? The failure to manage transactional cost at the fund level … provides a compelling case for Government intervention.* EBC

At present, there are two main formats for product charge disclosure for pension schemes and plans. The annual management charge (AMC) deducted from member funds covers investment and 'administration', among other features. The total expense ratio (TER) is a more comprehensive measure of the member's total annual cost than the AMC, but is still not complete.[24] The TER comprises the AMC and fees for a range of services including legal, administration, audit,

22 A good example would be the disclosure of transaction costs for real estate funds. Where the asset class is accessed via a fund of directly-held UK real estate, this would show the cost of buying and selling properties. Where access is via real estate companies, such as real estate investment trusts (REITs), such transactions would not be shown, as the fund would purchase equities in the property companies; therefore trading costs would be implicit in the price, not explicit.

23 According to one interviewee, full disclosure would include: bid-offer spreads (in particular the impact of the market on poorly managed trades); transaction costs of underlying funds when a fund invests in another fund; profits from stock lending retained by fund managers; interest on cash balances retained by fund managers; and FX spreads on currency hedging. One estimate of hidden costs has been expressed in 'the Plexus Iceberg' diagram, after a piece of research by the Plexus Group in 2005. The research breaks down costs as follows: visible costs = 9 bps; bid-offer spread, market impact costs, information leakage = 12 bps; delay costs = 21 bps; missed trade opportunity costs = 9 bps. The visible costs (commissions, taxes, fees, custodial charges, etc.) comprise 18% of total costs. The hidden costs (bid-offer spreads and other costs due to market impact effects and inefficient market timing) comprise 82%. The hidden (underwater) costs are therefore of material significance. The Plexus Iceberg is discussed by Madhavan, A., Treynor, J.L., and Wagner, W.H. (2007) "Execution of Portfolio Decisions", in *Managing Investment Portfolios: A Dynamic Process*, edited by Maginn, J. L., Tuttle, D.L., McLeavey, D. W., and Pinto, J. E. John Wiley & Sons, Hoboken (Chapter 10, pp.637-681).

24 In addition there is the 'ongoing charge'. See http://www.investmentuk.org/current-topics-of-interest/charges/. However, definitions of 'on-going charges' are drawn from EU law that applies to retail unit trusts. As far as we are aware, this measure excludes all transaction costs (including those of sub-funds).

marketing, directors' fees, regulation and 'other'. However, providers vary in what they include in each of these measures; in some cases a stated TER only includes an AMC. Moreover, while most schemes have a single charge a minority have an AMC and an additional charge, for example NEST's contribution charge and NOW: Pension's monthly administration fee.[25]

Comparisons, therefore, are very difficult, and are made more so by the practice of underwriting employers ,i.e., agreeing different terms with different employers. Some providers offer the same charge to members irrespective of the employer and employee profile. Others underwrite each employer individually and, in general, impose a higher member charge where the membership profile is less profitable (and also, we were told, where the employer is less knowledgeable). The underwriting takes into account a range of factors, the most important of which are the earnings profile of eligible workers and the staff turnover rate. Most providers decline employers – for example, those with low-paid employees and high staff turnover rates – where they determine that they cannot make the required minimum return on capital within the AMC/TER.

There are further differences that apply within an employer's arrangements. Where an employer is advised to segment the workforce, there might be a difference in the member charge between the two providers. It is possible that in the scheme for the more profitable segment, members will pay a lower charge than if the whole of the workforce were in the same scheme. Schemes for the more profitable segments tend to offer a wider investment choice and more sophisticated member communications, which might include pension modelling tools, for example. Other variations include providers that reduce the member charge once the member's fund reaches a certain size.

A particularly controversial practice is the use of active member discounts (AMDs), where current employees pay a lower charge than deferred members. The OFT found that the median additional cost for deferred members was about 0.47% a year and the DWP proposes to ban such arrangements.

> *AMDs do little good and are a long-term recipe for disaster – especially when applied in industry sectors and with employers where there is high staff turnover. We do know of one or two schemes where AMDs have been negotiated where the deferred member charge is under 0.75% (indeed on one scheme under 0.5%). If the policy intention is to remove AMDs for philosophical reasons then we say 'just do it'. If the intention is to limit opportunities for funds to avoid the cap (by having active members below 0.75% and deferreds above) then simply including deferreds in the equation will do the trick. To level the charges on schemes with AMDs, active member charges would typically have to increase by 0.25%* EBC

Schemes have the right to change their member charge in future. Some providers – and these tended to be those with the same charge for all members – said that their long-term objective is to reduce the charge. Other providers – and these tended to be those with differential charges, depending on the employer profile – reported that they might increase the charge for future members if, for example, the membership profile changed or they did not achieve the anticipated market share.

25 While dual charging structures make comparisons difficult, they also raise the question of the most appropriate charging format. It could be argued, for example, that dual charging provides better value over the longer term, since the lower AMC is beneficial where the fund is substantial, whereas a flat rate embeds cross-subsidies from members with larger funds to members with smaller funds.

In Section 2, we look at the member outcomes from a range of default funds old and new. The purpose of the present section is to consider the relevance of the component parts of the TER in relation to value for money for members. The first point to note is that the asset management charge is not the most expensive reported item in a default fund, but typically accounts for 20-25% of the TER in a modern scheme. So, for example, where the TER is 0.5%, the reported cost of asset management might be just 0.1%. If this is genuinely the full cost, the implication is that the focus for member VfM should be directed to other components of the TER. However, it also underlines the imperative of full-disclosure. In some schemes, a reported cost of 0.1% will be close to the full and true cost of asset management. In others, it will be a significant under-estimation.

There are two issues we examined under charges. The first was the cost of the separate component parts of the AMC/TER. We invited a representative range of modern schemes to provide details of the cost of these components, as a percentage of the total TER. Our full request for information was as follows:

- The cost of third-party services, including:
  - Governance
  - Trusteeship
- Regulatory fees / compliance costs
- Asset management (total cost of the default investment strategy)
  - If your appointed asset managers engage in securities lending, what share of total revenue and costs is retained by the scheme for the benefit of its members?
- Asset management (including fiduciary / implemented services)
- Platform charge / fund administration
- Scheme administration and member record-keeping
- Set-up costs, eg:
  - Design/implementation of the platform
  - Payroll integration for employer compliance
- Member communications
- Marketing (including advertising)
- Distribution
- Other charges, including:
  - Accounting
  - Auditing
  - Custody
  - Legal
  - Research
  - Valuation

In several cases, we were given confidential information about the specific cost of the asset management component of the TER. In one case, we were told that the cost of marketing and distribution was borne by the provider. In most cases, we were told that all the component parts were included in the AMC or TER and that further detail was confidential.

The second consideration was what functions were included within the different component parts of the TER – our concern being that the non-asset management costs appear high relative to the cost of the investment strategy. This is relevant because providers might include costs – under 'administration', 'marketing' and 'other', for example – that arguably the member should not have to bear.

We were told that administration is likely to be the most expensive item under the total charge, accounting for 15bps to 35bps in a typical scheme, which is quite a substantial range. Administration covers the costs of contribution administration, transfers in and out of the fund, annual member statements, the provision of a helpline, and certain regulatory costs, such as a per-member levy to TPR. These are clearly member services. However, our research indicated that administration, 'marketing', and 'other' costs can incorporate the cost of services to employers and to advisers. These services can be expensive to provide, of course; a good example being 'middleware', the software that enables employers to identify correctly the employees they must auto-enrol and the level of contributions. Indeed we were repeatedly told that employer compliance was the most challenging aspect of auto-enrolment implementation, especially where a high proportion of members opt out and must be re-enrolled, and where staff turnover is high.

We do not dispute the complexity of employer compliance, but we suggest that policymakers, regulators and those responsible for scheme governance should consider very carefully whether it is fair for scheme members to pay the costs of employer compliance, and, in particular, whether it is fair that they should pay for the services providers give free of charge to advisers in order to help them sell their schemes.

> *We need to challenge every basis point in that member charge and ask whether it delivers value to members.* Asset manager

One way of looking at this issue objectively from the employer perspective is to acknowledge that auto-enrolment represents an additional cost on labour. Assuming employers are not prepared to reduce their profits, there are only so many ways of recouping these costs, at least in part:

- Reduce the level of the employer contribution, where the existing contribution level is above the auto-enrolment minimum
- Reduce future wage increases (the model adopted in Australia, agreed by employers and trade unions)
- Pass on all costs to employees

The government should instigate an open debate on this issue to determine which is the most appropriate, economic and transparent method.

Finally on charges, it is crucial to address the overall 'cost' of periods of membership in older DC schemes, where the charges are high relative to

modern schemes and where the asset management might be suboptimal. We recommend a wholesale clean-up of older schemes and we do not think that the OFT-instigated audit of pre-2001 schemes goes far enough. A better solution for member VfM is to ensure that their assets in older schemes – including assets in the personal pensions of members who left a contract-based scheme – migrate to new schemes that offer demonstrable value for money, as defined in this report. A high proportion of these pots will be managed by consolidators (the 'zombie' funds) that do not look for new business and therefore are under no competitive pressure to reduce charges and improve returns. As we mentioned earlier, we recommend that there is a guided process for employees with older DC pots – irrespective of size – that facilitates transfers to modern schemes that meet VfM standards, as set out in this report.

1.4 Who's who on the sell side?

The changing shape of the provider market

In the late 1980s, when personal pensions and group personal pensions (GPPs) were introduced, more than 100 life offices, building societies and friendly societies sold DC products in the corporate and retail markets. The trend towards consolidation began in the 1990s and early 2000s and continued during the run up to auto-enrolment. In 2013, there were about 20 active players, although by the end of the year there were signs that several traditional providers might be on the point of closing to new business. Even within this comparatively small number, the research found very marked differences in terms of business model.

Historically, the DC scheme market has been very fragmented, characterised by a very large number of schemes with small memberships. Of the estimated 205,000 DC workplace schemes in 2012, only 5% had more than 100 members.[26] Schemes with fewer than 100 members accounted for 40% of AUM.

We expect the auto-enrolment market to be dominated by a small number of trust-based multi-employer schemes – possibly five or six. The period leading up to the end of 2018, therefore, represents a unique opportunity for providers to secure a viable share of the market. The short time scale for the market shake-out has triggered intense rivalry for business between traditional providers and new entrants. Moreover the distinctions between providers and advisers have become blurred. In particular, several EBCs and corporate advisers have launched their own schemes, while still retaining their 'independent' status, a situation which is permitted under the current regulatory system.

Life office schemes

Most life offices in the pensions market are proprietary companies; only a very small minority has retained the traditional mutual status or is not for profit. To date, life offices have mainly sold contract-based schemes, but several of these providers have launched trust-based multi-employer schemes ('multi-trust') for the auto-enrolment market. In addition, most life offices offer stand-alone asset management and administration services, while their asset management arms provide single and multiple asset class funds to (mainly trust-based) schemes on a third-party basis.

26 For DC market analysis, see Spence Johnson's 'Broad Brush' reports, in particular numbers 7 and 10: www.spencejohnson.com/TheBroadBrush.html

In 2013, the ABI listed the following 11 member firms (life offices) that provided qualifying auto-enrolment schemes:

- Aegon
- Aviva
- B&CE's The People's Pension
- Fidelity
- Friends Life
- HSBC
- Legal & General
- Prudential
- Scottish Life
- Scottish Widows
- Standard Life

The key distinguishing feature of life offices is that they have traditionally sold their schemes through EBCs and corporate advisers. This will continue to be the case under auto-enrolment, although we understand that some providers will also accept employers directly. Where they do, they might not advertise this fact openly, as they are anxious not to alienate the advisers on which they rely for the bulk of their business.

New multi-employer schemes (trust-based)

There are several new trust-based multi-employer schemes, the most prominent example of which is NEST, the government-established national scheme, which has a public service obligation to accept any employer. The line-up in this market includes:

- B&CE's The People's Pension (B&CE is also an ABI member)
- BlueSky
- NEST
- NOW: Pensions
- The Pensions Trust
- SuperTrust

The key distinguishing feature of most (but not all) of these schemes is that they are not-for-profit organisations. Unfortunately, 'not-for-profit' is poorly defined and we would like to see better evidence of this status in relation to the distribution of surplus and member value for money.

Single-employer schemes

A third category is the single-employer scheme – typically, but not exclusively trust-based – which was already part of the landscape pre-auto-enrolment. In this case, the employer almost certainly would have provided a DB scheme in the

past, which is now closed, and uses the same trustee infrastructure to oversee its DC scheme. The default fund is likely to be constructed by investment consultants appointed by the trustees.

The key distinguishing feature of single-employer schemes is supposed to be the strength of the trust board, which typically was developed for the DB scheme. However, DB skills do not necessarily confer DC expertise and can lead to over-complexity in active investment strategy, which might not offer the best value for money for the membership profile. For example, we are aware of employers with high staff turnover and a significant proportion of low-to-median earners that have allocated 50% or more of the default fund to a diversified growth fund (DGF), which means that the member charge is likely to be well in excess of the 50bps available elsewhere in the multi-employer market. We are also aware of trustee boards that strongly favour active over passive management, which again results in a higher than average member charge and the potential for greater volatility in fund values.

Consultants' schemes

The fourth type of provider – the EBC or corporate adviser – is relatively new. Here the adviser constructs its own scheme and uses third-party asset manager funds for the default fund. We understand that the following firms offer schemes:

- Aon Hewitt
- JLT
- Mercer
- Xafinity

While the design of such schemes might be good, the entrance of advisers into provider territory has proved controversial, since the consultant still operates as an independent adviser to employers. In practice, the consultant would use a different arm of the business to deliver these two services, but this does not appear to have appeased opponents of the adviser-provider business model.

The use of third-party asset management

In theory, we might have expected the DC market to open up to third-party asset managers under auto-enrolment, but the research shows that manager participation in multi-employer scheme default funds is limited because most of these schemes are run by vertically-integrated (bundled) providers.[27] Notable exceptions include the consultants' own schemes, described above, and the following:

- NEST outsources on an asset class basis to construct its default funds. Mandates include:
  - UBS Global Asset Management Life Ltd: passive global equities
  - State Street Global Advisers (SSgA): passive UK gilts; passive UK index-linked gilts
  - BlackRock: sterling liquidity; diversified beta

27 This issue was explored in the Pensions Institute's October 2013 report, *Returning to the Core: Rediscovering a Role for Real Estate in Defined Contribution Pension Schemes*, http://www.pensions-institute.org/reports/ReturningtotheCore.pdf

- Legal & General Investment Management (LGIM): real estate
- F&C Global Asset Management: equity portion of the Ethical Fund
- HSBC Global Asset Management: Shariah Fund

- B&CE's The People's Pension outsources to LGIM for its lifestyled default fund asset management and to HSBC for its Shariah fund.
- The Pensions Trust and BlueSky outsource to AllianceBernstein, which in turn uses mainly third-party asset manager funds for its target date funds [28]

A small number of (generally passive) asset managers have strong relationships with life offices. Examples include SSgA, which provides the passive global equity fund for Scottish Widows' default fund, and Vanguard Asset Management, which provides part of the asset management for one of Standard Life's passive default funds.

The changing shape of the adviser market

As noted above, historically, the DC scheme market in the UK has been heavily intermediated, i.e., most life offices have sold exclusively through EBCs and corporate advisers. The distinctions between EBCs and corporate advisers have blurred over the years, but a broad-brush description can be offered as follows:

- **Employee benefit consultants (EBCs)**: Often referred to simply as 'consultants', these advisers also provide actuarial and investment consulting. Examples include the top three by size (Aon Hewitt, Mercer, and Towers Watson), the mid-sized consultants (e.g., Hymans Robertson, JLT, Lane Clark & Peacock (LCP), and Xafinity), plus regional firms. Also competing in the consultancy market are the accountancy firms, such as Deloitte, Ernst & Young, KPMG, and PwC.
- **Corporate advisers**: These firms are often referred to simply as advisers, although the term 'corporate' is used to distinguish them from the advisers that only operate in the retail market. We do not provide examples here, as many corporate advisers prefer to describe themselves as EBCs.

There are several reasons why the role of advisers is changing and their number is likely to shrink:

- **Pensions are bought, not sold**: The first reason is that pension schemes no longer need to be sold; employers must buy them and they can buy direct.

  Previously, when having a scheme was optional, we had to pay advisers to bring employers to the table. Now the legislation brings employers to the table, it is not clear how our relationship with advisers will change. Scheme provider

  Currently EBCs and advisers are evaluating their business models and are wondering if the writing is on the wall for their pension services. They are struggling to justify a role in a market where they no longer need to sell, but where employers are required by law to make a purchase and can do so from the factory gate. Scheme provider

  However, while there has been a lot of talk about disintermediation, buying

28 In this respect, AllianceBernstein provides an outsourced fiduciary or chief investment officer service, similar to NEST's in-house function.

from 'the factory gate' requires providers to offer employer support to ensure they meet their legal duties. Schemes that will accept employers directly told us that they see a continued role for advisers.

The point here is that the adviser must offer genuine value in return for the employer's fee and not sell services that are not really required and which extract value through the member charge. Scheme provider

- **The choice of schemes will become limited**: The second reason that the traditional adviser role is under threat is that the need for help in scheme selection will diminish over time, as the number of major providers in the market contracts.

  Employers needed advisers in the past because there were dozens of providers to choose from. If that number shrinks to half a dozen, it will be much easier for employers to make the choice without help. Scheme provider

- **Joint ventures confer added sales power**: Third, providers are securing distribution through joint ventures with EBCs, such as the agreement between Standard life and Barnett Waddingham, a mid-sized EBC.[29] As a delivery vehicle in the SME market, this 'decision-light' consultancy model is likely to become increasingly common: it offers the provider distribution opportunities and it reduces the regulatory burden on the EBC, which otherwise would be required to undertake a thorough examination of each employer's workforce and to select a scheme from the whole of the available market.
- **Web-based selection offers a cheap alternative**: This is another 'decision-light' option for SMEs. Here providers sell through web-based scheme-selection services that identify the best scheme for the employer (from a panel) and provide an actuary's certificate of employer due diligence in return for a one-off fee, e.g. £500.[30]

Advisers can play a crucial role in promoting the scheme to employees, although under the voluntary system, this might have been to a segment of the workforce for whom the employer targeted employee benefits. In our 2004 report, *Delivering DC*, we found that advisers frequently were requested by employers to keep participation rates low to reduce the potential cost of the employer contributions.

Under the new system, where employees are enrolled automatically, an important role for advisers is to encourage members to stay in the scheme. For this to work, they will need the support of the employer. Under the regulations, employers are forbidden from offering inducements to opt out, but they are not required to promote the benefits of staying in the scheme.

Where employers will not pay for advice, we believe that the challenge of achieving high participation rates among smaller SMEs and micro employers is unlikely to be met by advisers, but will rely on the providers' direct contact with members.

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29 http://www.barnett-waddingham.co.uk/ae/

30 The first of such services was Pension Playpen, run by First Actuarial, https://www.pensionplaypen.com/

1.5 VfM for whom? Disconnections at every stage in the supply chain

VfM for members

The common factor that unites the DWP, OFT and Law Commission reports is the desire to understand and define what 'good' means in relation to DC pension schemes under auto-enrolment. We argue that 'good' should be measured in terms of value for money (VfM), which can only be evaluated where the beneficiary is clearly identified. This sounds an obvious point, but the research discovered that the identity of the beneficiary of a scheme's value for money is far from clear.

Logically, we might assume that VfM refers to the member, who is the investor and who pays for scheme costs through the TER. VfM for members of default funds might be summarised as a combination of the following factors:

- A TER in the region of 0.5% a year for the accumulation period (at current levels of scale)
- A multi-asset default fund with a glide path that is subject to regular modelling scrutiny in relation to the member income replacement ratio (RR) and the downside risks.
- Expert independent governance fully aligned with all members' interests.
- Effective member communications that focus on improving the outcome, e.g., paying higher contributions, working longer, and/or delaying the annuity purchase date.
- An efficient consolidation system that helps members to transfer older DC pots to the new scheme, where these are held in poorly diversified funds with higher charges.
- A decumulation service that is part of the scheme and provided by a specialist retirement-income adviser that adheres to robust service standards.

However, for providers, there are two other parties in the supply chain for which delivering value for money is a major consideration:

- The employer, which chooses the scheme, and which, in effect, acts as the unregulated agent of the provider and adviser (where applicable)
- The adviser, who sells schemes to employers on a fee basis and whose advice is also unregulated

We consider these two parties, in turn, in the context of the supply chain.

VfM for employers

We first considered the peculiar role of the employer in the supply chain in *Caveat Venditor* and said:

> *The employer is the buyer, but not the customer; the member is the customer, but not the buyer, and therefore has no influence over the choice of scheme to which he or she is passively auto-enrolled. The employer has no responsibility for member outcomes, in law or in regulation.*[31]

31 This again confirms why the FCA COB regulatory regime does not work for auto-enrolment.

This was not the case under DB, where employers were the customers because they bore the bulk of the financial risks inherent in the scheme. Under DC, the employer is the 'customer' (purchaser), makes a contribution to the member's pot, but bears none of the financial risks. There is a business risk, of course, but this does not apply to all employers; much depends on the size and age profile of the workforce. As we noted in *Caveat Venditor*, if employers do not provide adequate pensions they will lose control over retirement management, since employees will not be able to afford to retire and the law no longer permits enforced retirement based on age. However, where the employer's workforce is characterised by high staff turnover and/or by a younger employee profile, retirement management will not be a priority and therefore this cannot be relied upon to change employer attitudes, certainly not in the short term.

From a supply-side perspective, the employer market can be divided into two tiers, which, from a pension scheme perspective, can be described as 'traditional' (with a history of pension provision) and 'new' (with no history of pension provision). Already, it is clear that certain providers and advisers will only or mainly deal with traditional employers and in some cases only with the larger companies.

> *We are almost through our auto-enrolment workload and should be finished in early 2014 when the SMEs start reaching their staging date. Some of the providers are saying the same thing – they expect to be closed to new business by 2015, possibly earlier.* EBC

> *The joke going round among the big consultants is that 'auto-enrolment is so last year'* EBC

However, innovation among EBCs, for example in helping schemes to target member outcomes more effectively, might influence scheme design for SMEs.[32]

The traditional employer market

The traditional employers are the large and medium-sized companies that were pensions-friendly under the voluntary system because they believed that offering membership of a scheme was an essential component of their employee benefits packages. They still believe this, but not necessarily in relation to the majority of the workforce which must now be auto-enrolled. A key indicator of the attitude of the old-market employer is the pre-auto-enrolment scheme participation rates. In some cases, participation rates were high, but generally they were not, which indicates that membership of the pension scheme was perceived by employers as a valuable benefit for valued employees, i.e., the skilled long-stayers. In this respect, the employer's objectives were well aligned with those of the provider and adviser, since steady and stable earners represented an attractive economic proposition.

Some of the larger employers have a single trust-based scheme, usually designed by an EBC. They might continue to use this for auto-enrolment, but there are reasons why they might review this decision in due course. At present, employers tend to use the trust infrastructure of their closed DB scheme for the

32 For an example of targeted outcomes, see http://guidedoutcomes.hymans.co.uk/why-go/

auto-enrolment DC scheme. Once they have eradicated the DB scheme from the balance sheet through a bulk purchase annuity buy-out, the cost savings from dismantling the trust scheme infrastructure and outsourcing the DC scheme might look very appealing. This is a worrying prospect, as one EBC explained:

> *Consultants with their heads in the sand think that the closed DB scheme market will last for ever. This is certainly not what TPR wants. It wants schemes to reach full solvency in about 10 years. Once that happens, employers will be keen to get rid of their schemes a.s.a.p. Great news for the buy-out market; not so great for the actuaries, the DB asset managers, the pension lawyers, and so on.*

For reputational reasons, the largest employers that have gone to the new multi-employer scheme market generally have introduced one scheme for all employees, although there might be a 'nursery' section for the first two years to deal with the segment of the workforce associated with high staff turnover. Medium-sized employers might take the same route, but providers in this market are also offering a different proposition based on the segmentation of an employer's workforce, whereby the profitable employees remain in the existing scheme and the bulk of the membership is auto-enrolled into a multi-employer scheme that accepts most or all employee profiles, e.g., B&CE's The People's Pension, NEST, or NOW: Pensions.

This cherry-picking approach to workforce segmentation on the part of employers, providers and advisers is likely to become a feature of auto-enrolment in 2014. It is a supply-side strategy and is not necessarily driven by demand. Indeed, it is not clear whether the dual scheme structure is of real benefit to employers, particularly in the SME market, where the additional complexity associated with managing two pension schemes might be undesirable. What is clear, however, is that the strategy is of benefit to the providers in the SME market, some of which have publicly expressed concerns about the cost of delivering auto-enrolment across entire workforces where previously they had only served a small (profitable) section. Put simply, they do not want to deal with the lower contributions and higher turnover rates associated with many employees.

While we understand the economics of cherry-picking from the provider perspective, from a policy perspective it is problematic. Employers with an existing scheme might reasonably assume that their provider will take on the rest of the workforce. This is not the case. We were told of examples where employers were being turned down, having assumed that they were ready for their auto-enrolment staging date in 2014:

> *Employers are furious. Understandably they assumed they could rely on their existing provider and are finding out at the last minute they are not wanted. Unless they are prepared to run two schemes – and many are not – all their planning for auto-enrolment has to start over.* Scheme provider

Moreover, while diversification in providers' business models is inevitable, it does raise potential problems for market analysts. For example it will be difficult to make any superficial comparisons between schemes used solely for the more profitable sections of the workforce and schemes that accept all memberships, since the former are likely to have higher employer and employee contributions based on above-average earnings.

An additional practice that has been criticised is the provider's implementation charge, which might be, say, £20,000.

> *We come across cases where everything was signed off and then the provider told the employer there would be an additional £20,000 for workforce assessment. It looks like providers that adopt this practice are hoping that the employers will feel committed and just pay up.* EBC

The new employer market

The new market refers to employers that did not buy (or were not sold) a scheme under the voluntary system. Numerically this is the vast majority: of the 1.3m employers due to auto-enrol, nearly 1m have fewer than 10 employees.

The objectives of new employers in the SME market are very different from those of the traditional, pensions-friendly employers. New employers are being brought into the market by the force of legislation. Most will have no pre-existing relationship with advisers and in many cases they will not be an attractive proposition.

> *There is a good reason why so many SMEs have not got a pension scheme – it's because they were not perceived as attractive economic propositions, i.e. profitable, to commission-based advisers and to the providers they served.* EBC

The chances that these employers will pay a fee to advisers are slim.

> *These employers are unlikely to pay a fee for advice. They will go direct to NEST or one of its competitors, which are set up to deal with employers directly. Even where these schemes gain business via advisers, this will be because they are being used by the cherry-pickers as a dumping ground for uneconomic sections of the workforce* EBC

The dynamics of the supply chain are very different in this second tier of the market. For many of these employers, auto-enrolment will not be about providing attractive employee benefits (although employers might change their minds on this point over time). Instead, auto-enrolment will be about compliance with the new legislation: that is, they need to enrol and re-enrol the right employees at the right time at the right level of contributions. So this is a 'minimum wage legislation' scenario; not a sudden change of heart over employee benefits.

Accordingly, provider services to employers now include the provision of free pension/payroll software that identifies which employees must be auto-enrolled (and, for opt-outs, re-enrolled), the date of enrolment, and the correct level of contributions, which might fluctuate depending on the component parts of the wages. The term used for this function is 'middleware'. Unless purchased as a separate piece of software, employers can get this service free from providers and also from many advisers, which means that in most cases the member charge covers the cost. We were unable to determine where this cost was positioned in the component parts of the TER, but believe it might be part of 'administration', 'marketing' or 'other' costs. We question whether such practice is fair and suggest that it might undermine member value for money.

However, it is possible that the problem will be short-lived. The research indicates that in future auto-enrolment compliance will no longer be perceived as a

pension problem that requires a pension solution, but as a payroll problem that requires a payroll solution. Payroll systems, already developed for the largest employers (usually on a bespoke basis) are now being designed for the mass market, so that employers of all sizes should be able to afford to update their software, with the possible exception of micro-employers. This still leaves the important matter of member communications, but we understand that providers are prepared to undertake this task. Providers are also likely to manage re-enrolments where this function is not incorporated in the payroll software.

No doubt the debate over which compliance functions are 'pension' and which are 'payroll' will continue, but we suggest that the government and regulators consider what SMEs need rather than what pension providers and advisers want to sell, and also consider what it is fair for the member to pay.

VfM for corporate advisers

Our research indicates a growing disconnection between the corporate advisers' traditional role and the new requirements of employers in the SME market. This disconnection might not be apparent at present, partly because employers are struggling with the legal complexity of auto-enrolment as they prepare for their staging dates, and partly because the pensions industry is doing a very good job in convincing employers that auto-enrolment compliance is a pension problem that requires a pension solution. While this might be true in the traditional employer market, as we said above, for many new employers the real challenge appears to be getting the payroll software to deal with auto-enrolment.

For corporate advisers, the timing of auto-enrolment is unfortunate because the Retail Distribution Review (RDR) came into force on 1 January 2013 – just a few months into the employer phasing period. At this point, advisers lost the right to sell schemes on a commission basis, an arrangement thought to be worth about £200m in the pre-RDR DC scheme market.[33]

> *The market is currently best described as febrile. [Formerly] commission-based advisers are struggling to advise on workplace pensions and have reverted to other ways to create annuity [regular fee-based] business, typically through levying per capita charges to employers for assessing their workforces for auto-enrolment. This is increasingly leaving an advice gap for smaller firms setting up workplace pensions from 2014. The market has been slow to build alternative sources of guidance and support to allow the SMEs and micro employers to 'stage themselves' with good quality workplace schemes.* EBC

Clearly the move from commission- to fee-based advice is also a problem for providers in the SME market which hitherto have relied on paying commission to secure distribution. Some would argue that before January 2013, if providers

33 Commission on new sales was banned under the Retail Distribution Review (RDR), which came into force on 1 January 2013 (http://www.fsa.gov.uk/rdr). The ban on the consultancy charge was announced shortly afterwards by the government in (https://www.gov.uk/government/news/government-announces-clampdown-on-pension-charges). Commission was embedded in the member's AMC as an annual percentage, which might be significant in the first year of membership (e.g. 20%) and then continue as a 'trail' commission of 0.5-1%. Trail commission is still embedded in the AMC of members of schemes sold pre-RDR, and applies to new members auto-enrolled into these older schemes after January 2013. The government is likely to exclude schemes with embedded trail commission from being used for auto-enrolment. The source for the figure of £200m was Deloitte, quoted in *Corporate Adviser* November 2013.

wanted to increase market share, they could increase the commission rate. 'Commission wars' have led to scheme churn – the last being in 2012 before the commission ban came into force.

> *If the FCA wanted to discover the extent of scheme churn in 2012, all it has to do is look at the accounts of the corporate advisers in the market. Why hasn't it done this?* EBC

The government has proposed a ban on commission-based schemes used for auto-enrolment. This would have a significant effect on advisers and providers:

> *The impact [of a commission ban] on advisers reliant on commission would be severe. Much future commission is already baked into business projections, if not into the balance sheet. A ban on commission would materially impact the corporate advisery market and drive many commission based advisery firms into administration.* EBC

> *Commission does represent a barrier to switching as advisers still have a strong influence on their clients. Advisers tell us that employers like commissions. This is a weak argument as commissions simply allow a pass-on of advisery fees from employer to employee. This practice has recently been extended to fund the administrative costs of auto-enrolment where the normal charge levied by the adviser is offset against future commissions.* Scheme provider

To help secure distribution in the fee-based advice market, providers have designed 'middleware' as an adviser service to the employer, but which will also 'double-up as a fee-charging solution' according to one provider that makes the software available free to advisers. The fee-charging solution includes 'issues' and 'tasks' the adviser would hope to address and complete in return for a fee per item calculator.

Of course, the middleware might offer much more than compliance, where it forms part of a benefits platform, but if compliance is all employers need, then there might be much cheaper ways to meet their needs.

1.6 Member VfM and regulation

Good governance is the key to member VfM, as defined in this report. Good governance, in turn, requires good regulation, by which we mean consistent regulation across the whole DC workplace scheme market that has a clear focus on member value for money and the responsible fiduciaries.

At present, we have a dual regulatory system and already there is strong evidence of regulatory arbitrage in the form of certain master trusts where the provider is the asset manager and also where the provider is an 'independent' consultant. Such schemes might well deliver member VfM, but we should not lose sight of the underlying principles of good governance, since smaller master trusts might prove to be hugely conflicted to the members' detriment.

We would argue that it is time for the government to confront the issue of pension regulation – otherwise the best it can hope to achieve is to paper over the governance cracks as they become visible. The current dual system of regulation whereby The Pensions Regulator regulates trust-based schemes and the Financial Conduct Authority regulates contract-based schemes should be

reformed. Without some reform, the implementation of auto-enrolment will continue to be based on the unsteady principle of 'ready, fire, aim'.[34]

We turn now to an examination of charges and investment strategy – two of the key quantifiable components of value for money. We consider a representative range of default funds currently available in the UK and model their impact on potential pension outcomes for scheme members who end up in the default fund. We also consider examples of older funds that might no longer be sold, but which might still account for significant AUM.

34 Invented by Spike Milligan

Section 2: Modelling value for money in default funds

2.1 Introduction

In this section, we present the results of modelling from the full spectrum of default funds currently used for workplace DC pension schemes. We believe these funds are representative of the funds that will be used by the majority of employers for auto-enrolment: balanced managed funds sold by life offices in the 1990s (denoted by the label '1990' in the tables and figures below), 100% equity funds sold in the mid-2000s (denoted by '2000EQ'), balanced managed funds sold in 2012 as auto-enrolment was being introduced (denoted by '2012BM'), diversified growth funds (denoted by '2012DG'), funds designed by consultants for large single employers (denoted by '2012C'), and the new trust-based multi-employer schemes designed specifically for the mass market that has been created by auto-enrolment (denoted by '2013ME').

We express performance outcomes in terms of the 5-percentile point (denoted the 'lower bound' below) and the expected value of the simulated replacement ratio (RR) – the ratio of starting pension to final salary – that could be achieved by participating in each fund. These are more meaningful performance measures than the fund size at retirement because they take account not only of investment costs and risks during the accumulation stage of a pension scheme, but also of the cost of buying a lifetime inflation-linked annuity, which provides a guaranteed income for however long a scheme member lives. Moreover, the results can be applied to any earnings level.

Five thousand stochastic simulations of asset returns and member salary were generated using the PensionMetrics (PM) modelling software. We assume that a male employee is auto-enrolled onto his company pension scheme at the age 25 with a starting salary of £26,664 (approximately equal to average UK earnings in 2013). For each year of his investment horizon, we assume that 8% (consisting of a 4% employee contribution, a 3% employer contribution, and 1% tax relief) of qualifying earnings (earnings in excess of a threshold initially set at £5,668)[35] are put into one of the funds. The nominal economic growth rate forecast is 4.75% and the CPI (consumer price index) inflation rate forecast is 3.2%.[36] The growth rate of salary follows the economic growth rate with an adjustment for the member's career salary profile, which is assumed to be that for an 'average' male.[37] Further details of the asset allocation strategies (AASs) and the charges are given in Appendix 2. Charges are deducted annually from each accumulating fund value as per its contract. At the end of the investment horizon of 40 years, the whole fund is used to buy a real (inflation-protected) unisex-

35 The threshold level of earnings for auto-enrolment were set at £5,668 in 2013-14. This implies that in our example, the first year's contributions are equal to 8% of qualifying earnings of £20,996 (£26,664 – £5,668), i.e., £1,679.68. We assume that both earnings and the threshold are indexed to real salary growth. The contribution rate is rate is therefore equivalent to 6.299% of gross earnings (i.e., £1,679.68 ÷ £26,664) in the first year.

36 Source: Appendix A, 'Scenarios Tested' in 'A Validation of the Methodology used in the Department for Work and Pensions' Ipen Model', DWP Working Paper 106, 2012 (research.dwp.gov.uk/asd/asd5/WP106.pdf)

37 For more details on the calibration of the career salary profile, see Blake, D., Cairns, A. J. G. and Dowd, K. (2007) "The Impact of Occupation and Gender Differences on Defined-Contribution Pension Plans", Geneva Papers, 32, pp. 458-482.

priced annuity at the current annuity rate.[38] The PM model used 5,000 Monte Carlo simulation trials per fund where each trial involved a different trajectory for asset returns over the relevant investment horizon.[39] The means, variances and covariances assumptions for asset returns were provided by RiskLab.

The two key features that influence our results – and hence reflect value for money – are the charges and asset allocations (including the de-risking glide path). We comment briefly on these features.

2.2 Default fund charges

In *Caveat Venditor*, we described the complex charging structures that result in a TER of 3% a year for older funds. Higher charges of up to 4% a year were encountered in that study. Modern funds have much lower explicit charges, but, in some cases, these disguise higher implicit charges, as the recent Lane Clark & Peacock report discovered in the case of diversified growth funds, where the cost of investing in sub-funds could add 50% to the headline rate.[40] LCP's 2012 report also noted the different charges that apply to the same funds, depending on the access route. For example, a large trust-based scheme that buys a fund direct from the asset manager might pay less than half the price a stakeholder scheme pays for the same fund.

A further issue that has a significant impact on the final pension is the impact of changing jobs. In the quantitative modelling results reported below, we have assumed continuous membership of the same fund for 40 years. In practice, many employees change jobs quite frequently and therefore will belong to several schemes. If a fund provider imposes an exit charge on transfers, clearly this will reduce the final pension. The same is true in the case of the common practice of increasing charges on funds where contributions cease, which continues today in the form of 'deferred member penalties'. In short, job changes tend to lead to lower DC pensions (other things equal) – just like they do with DB pensions – challenging the supposed full portability of DC pensions, a key reason for their introduction in the 1980s.[41]

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38 We have assumed for modelling purposes that the full fund is used to buy an annuity to provide retirement income, even though every member has the right to use 25% of the fund to take a cash-free lump sum and that many of the default fund's de-risking glide paths assume that this right will be exercised (i.e., the glide paths end up with a fund which is invested 75% in bonds and 25% in cash). Our rankings of the different funds are not sensitive to whether we assume that the whole or just 75% of the fund is annuitized. They are also not sensitive to whether the annuity is index-linked or not.

39 We also chose not to report other financial risk measures. For example, the standard deviation of investment returns does not convey any useful information about either the probability of failing to achieve a target RR or the likely size of the RR if the fund is below the target. Similarly, measures such as tracking error relative to an index are flawed because risk is considered without reference to the real implicit liability in a DC scheme, namely the member's pension in retirement. As one asset manager put it, 'How can we have a conversation about quantifying and mitigating risk, if we can't agree on the base position by which we are measuring risk?' In short, we believe that the only sensible base position for measuring risk is to look at the distribution of replacement ratios.

40 See www.lcp.uk.com/news--publications/news/2012/pa/lack-of-clarity-on-dc-pension-fees-prevails-as-additional-costs-increase-total-charges-by-as-much-as-50perc-says-new-lcp-report--1/. For the 2013 report, see http://www.lcp.uk.com/media/615166/lcp_investment_management_fees_survey_2013_web.pdf

41 Appendix 3 shows the results with shorter investment horizons.

2.3 Asset allocation and the de-risking glide path

An important feature of the modern consultant-designed and trust-based multi-employer schemes is the dynamic asset allocation process. The older style life office funds have a static asset allocation: it is fixed at the outset and does not change, except during the linear de-risking glide path in the five or so years prior to retirement (although de-risking was not common in the very early funds).

It is clearly too early to judge the success of the new dynamic asset allocation strategies, but the principle of investment risk management in DC schemes – the equivalent of liability-driven investing in defined benefit schemes – is a sound one. This because it enables those responsible for governance to act promptly to address issues such as a change in the economic or investment climate, or a change in taxation or legislation. In addition, dynamic asset allocation can respond more flexibly to changes in member behaviour, for example a trend towards later retirement.

However, we need to distinguish between dynamic asset allocation strategies that are specifically designed to manage investment risks or respond to changes in member circumstances – and delivered through an agreed investment governance framework – and dynamic asset allocation strategies where the manager has full discretion. In the case of the former, there is a prescribed review process and the scope for potential adjustments to the asset allocation is limited; in the case of the latter, the asset allocation reflects the individual fund manager's judgement.

Our study only covers the former type of dynamic asset allocation strategies. Where such strategies are used, we have been given confidential access to the specific asset allocation strategy that the fund provider believes will be typical for each year of the plan.

Another important trend in DC investment has been a greater use of diversification to reduce volatility. This is reflected in an increasing use of so-called 'alternative' asset classes, such as real estate, private equity, hedge funds, infrastructure and commodities. The funds that use these new asset classes are known as 'diversified growth' (or 'strategic blended' or 'new balanced management') funds. However, the new trust-based multi-employer schemes, like NEST, also incorporate alternative asset classes. For example, in 2013 NEST introduced a weighting of 20% to 'real' assets. This was achieved initially through a 20% weighting to real estate, but in due course other real asset classes will be included in the weighting, such as infrastructure.

De-risking glide paths work in two main ways. The conventional method is 'lifestyle' or 'lifecycle', where the member's fund is gradually switched into low risk assets, such as bonds and cash. 'Target date funds' have the same strategy, but they operate on a cohort basis, so there is a fund for each cohort of members, depending on their expected retirement date, and the de-risking takes place on a discrete basis within each target date fund.[42]

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42 There is a third model, 'managed DC', which provides each member with an individual asset allocation profile designed to meet the target lifetime income. This US model is a recent innovation in the UK and there are only a few examples at present. One example is the SuperTrust multi-employer scheme, which uses the managed account funds run by Dimensional Fund Advisers (http://www.supertrustuk.com).

Glide paths were traditionally linear and deterministic, but some of the more recent providers' glide paths – like the asset allocation strategy itself – are managed on a dynamic basis, so that de-risking takes place in the context of market movements.[43] For schemes that target a specific annual return within a target date fund, this means that the glide path might start earlier or later depending on the realized performance of the fund in the preceding years. We provide details of the charges and some details about the asset allocations of the funds considered in this study in Appendix 2.[44]

2.4 Quantitative modelling results

We begin by projecting the performance of our funds over a 40-year investment horizon. The results are shown in Tables 1-3. Table 1 presents the lower bound and expected values of the projected replacement ratio at retirement. The former varies from 6.1% to 11.1%,[45] and the latter varies from 15.36% to 23.84%. Table 2 gives the rankings by the lower bound of the replacement ratio: by this criterion, the top ranking scheme is 2012ME9, the second best ranking scheme is 2013ME6, and so on, and the bottom ranking scheme is 2000EQ. Table 3 gives the rankings by the expected replacement ratio: by this criterion, the top ranking scheme is 2012C3A, the second ranking is 2012C1A, etc., and the bottom ranking is 1990D.

Table 1: Replacement Ratios after a 40-Year Investment Horizon
Retirement Replacement Ratio (%)

Scheme	Lower bound	Mean
1990A	7.18	16.92
1990B	7.61	16.37
1990C	6.88	15.88
1990D	7.31	15.36
2000EQ	6.1	18.6
2012BMA	8.37	19.71
2012BMB	7.5	17.09
2012DGA	9.72	19.01
2012DGB	8.66	16.51
2012C1A	7.49	23.04
2012C1B	7.06	21.18
2012C2A	7.91	21.72
2012C2B	7.42	19.98
2012C3A	7.46	23.84
2012C3B	7.02	21.88
2013ME1	9.71	20.14
2013ME2	9.78	19.85
2013ME3	8.42	22.25
2013ME4	8.88	20.58

43 This makes the glide path stochastic.

44 In a number of cases, the asset allocations were provided to us on a confidential basis. In other cases, the asset allocations are publicly available on the provider's website.

45 A higher 'lower bound' implies lower risk.

Scheme	Lower bound	Mean
2013ME5	8.21	18.55
2013ME6	10.4	20.23
2013ME7	9.58	18.25
2013ME8	9.22	21.37
2013ME9	11.1	19.17
2013ME10	10	20.43

Table 2: Ranking by Replacement Ratio Lower Bound after a 40-Year Investment Horizon

Scheme	Ranking
2013ME9	1 (11.1)
2013ME6	2 (10.4)
2013ME10	3 (10)
2013ME2	4 (9.78)
2012DGA	5 (9.72)
2013ME1	6 (9.71)
2013ME7	7 (9.58)
2013ME8	8 (9.22)
2013ME4	9 (8.88)
2012DGB	10 (8.66)
2013ME3	11 (8.42)
2012BMA	12 (8.37)
2013ME5	13 (8.21)
2012C2A	14 (7.91)
1990B	15 (7.61)
2012BMB	16 (7.5)
2012C1A	17 (7.49)
2012C3A	18 (7.46)
2012C2B	19 (7.42)
1990D	20 (7.31)
1990A	21 (7.18)
2012C1B	22 (7.06)
2012C3B	23 (7.02)
1990C	24 (6.88)
2000EQ	25 (6.1)

Table 3: Ranking by Replacement Ratio Mean after a 40-Year Investment Horizon

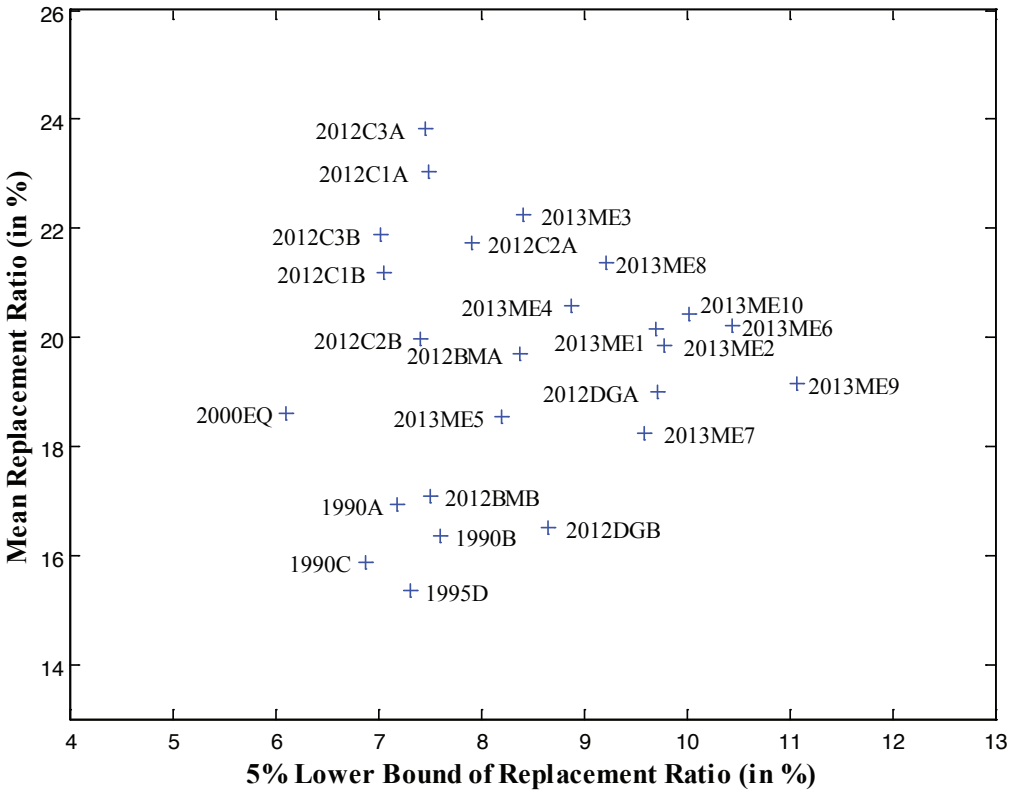
Scheme	Ranking
2012C3A	1 (23.84)
2012C1A	2 (23.04)
2013ME3	3 (22.25)
2012C3B	4 (21.88)
2012C2A	5 (21.72)
2013ME8	6 (21.37)
2012C1B	7 (21.18)
2013ME4	8 (20.58)
2013ME10	9 (20.43)
2013ME6	10 (20.23)
2013ME1	11 (20.14)
2012C2B	12 (19.98)
2013ME2	13 (19.85)
2012BMA	14 (19.71)
2013ME9	15 (19.17)
2012DGA	16 (19.01)
2000EQ	17 (18.6)
2013ME5	18 (18.55)
2013ME7	19 (18.25)
2012BMB	20 (17.09)
1990A	21 (16.92)
2012DGB	22 (16.51)
1990B	23 (16.37)
1990C	24 (15.88)
1990D	25 (15.36)

These outcomes are shown as a scatterplot in Figure 1. Movements in a north easterly direction indicate higher mean RRs and lower risk. The following schemes therefore lie on the 'investible frontier': 2012C3A, 2013ME3, 2013ME8, 2013ME6, and 2013ME9.[46] Two points stand out from this chart:

- There is a considerable variety of outcomes – that is, the scatter plot is quite dispersed. This indicates that the choice of scheme makes a considerable difference to the member's expected retirement income. The best scheme in terms of mean replacement ratio had a mean RR which was 55% higher than the worst scheme (23.84% compared with 15.36%). The best scheme in terms of the lower bound replacement ratio had a lower bound that was 82% higher than the worst scheme (11.1% compared with 6.1%).
- The modern schemes generally perform better than the older ones. The main reason is simply that the later schemes have lower charges. Thus, the higher charging schemes tend on the whole to offer lower value for money.

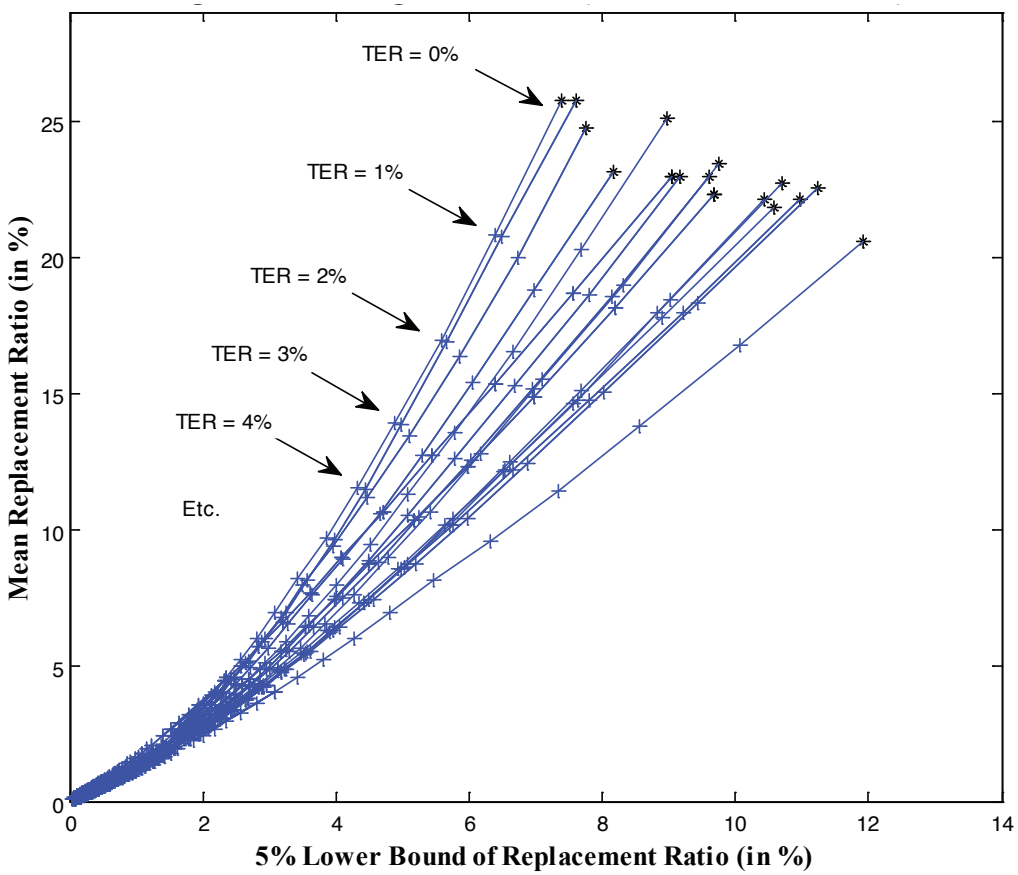
46 The 'investible frontier' is not the same as the 'efficient frontier'. Along the 'efficient frontier', schemes can only increase their mean RR by assuming more investment risk and vice versa. The 'efficient frontier' happens to be further to the north east in Figure 1 than the 'investible frontier', given the risk-return parameters we have used. Nevertheless, we can interpret the 'investible frontier' as being the practical risk-return tradeoff frontier for the schemes in Figure 1.

Figure 1: Replacement Ratios: Mean vs. 5% Lower Bound
(40 Years Contributions)



The impact of higher vs. lower charges is illustrated in the 'shooting stars' chart in Figure 2. In this chart, annual charges vary from 0%, 1%, 2% and so on up to very high levels, but all funds are assumed to have identical charges at any time. The chart shows the 'upper bound', based on a total expense ratio (TER) of 0%: this gives the limiting case as charges go to zero. The chart also shows what happens at the other extreme as well: as the TER gets very large, the outcomes fall back to the (0,0) axis as we would expect. It also shows some intermediate points where the annual TER is 1%, 2%, 3% and 4%. As a rough rule of thumb, each percentage point increase in the TER leads to a fall in the expected replacement ratio at retirement of about 20%, and to a somewhat smaller fall in the lower bound of the projected retirement replacement ratio. The chart therefore powerfully illustrates the effect of charges. It also shows for any given level of charges how close the different funds are to the 'investible frontier'.

Figure 2: Shooting Stars Chart
(40 Years Contributions)



We now turn to a different conceptual experiment. Suppose an individual has already been invested for 20 years in one of the 1990 vintage schemes, but decides to switch over to one of the better modern schemes, say, 2013ME8, for the remaining 20 years until retirement. What is the effect on the pension outcome? The answer is provided in Table 4 and Figure 3.

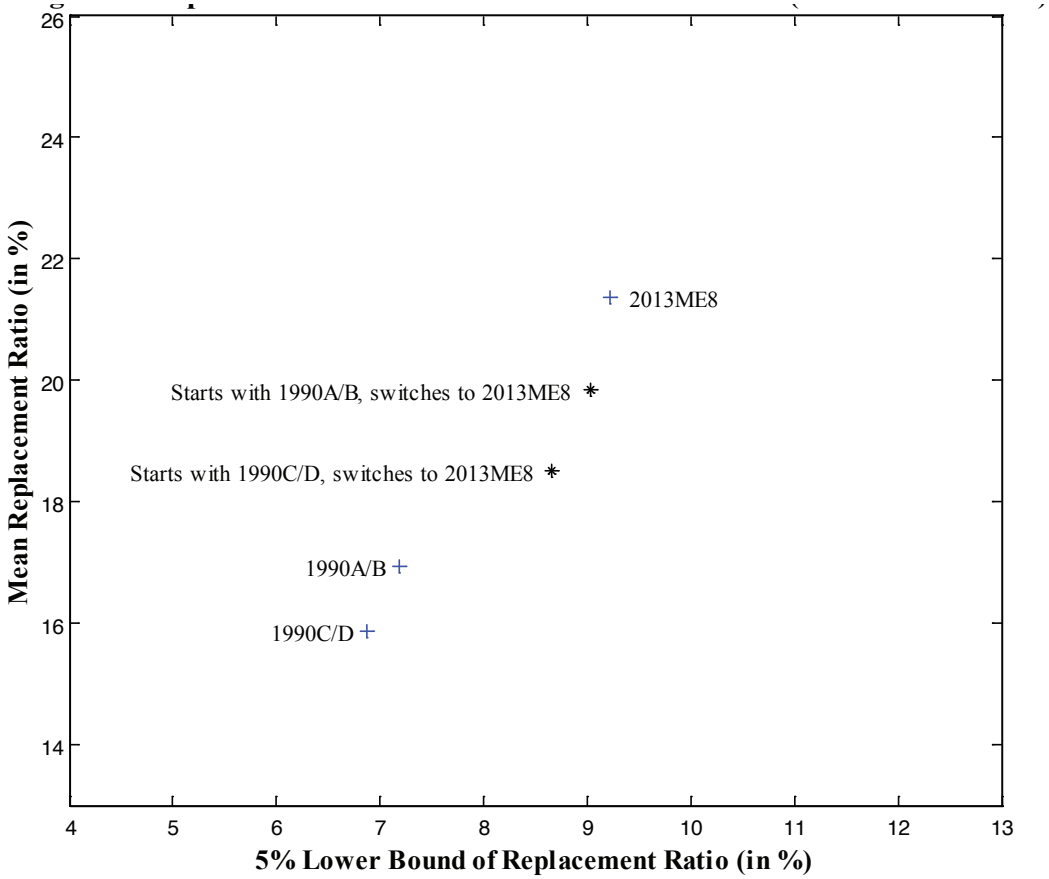
If he stays with the 1990A or 1990B scheme (where the annual TER is 1.5%), he gets a lower bound of 7.18 and an expected outcome of 16.92, in terms of the replacement ratio. If he had been able to invest in the ME8 scheme throughout his working career, he would get a lower bound of 9.22 and an expected outcome of 21.37. And if he starts with the former, but switches to the latter after 20 years, he gets a lower bound of 9.03 and an expected value of 19.83. This is on average 17% higher than if he stayed in the old high-charge scheme. The message here is that such an individual could still benefit considerably from switching across – although one should bear in mind that we have not considered any 'exit penalties' which might penalize him from switching. Such penalties would reduce but (unless they are grossly excessive) not eliminate the benefits of switching. The benefits of 'catch up' by switching from the older scheme to the newer one are even greater if he had invested in one of the 1990C or 1990D schemes, where the annual TER is 3% instead of 1.5%.

Table 4: Impact of Changing Scheme after 20 Years

	Replacement Ratio	
Scheme	Lower bound	Mean
1990A/B	7.18	16.92
1990C/D	6.88	15.88
2013ME8	9.22	21.37
Switches from 1990A/B to 2013ME8	9.03	19.83
Switches from 1990C/D to 2013ME8	8.65	18.52

Figure 3: Replacement Ratios: Mean vs. 5% Lower Bound

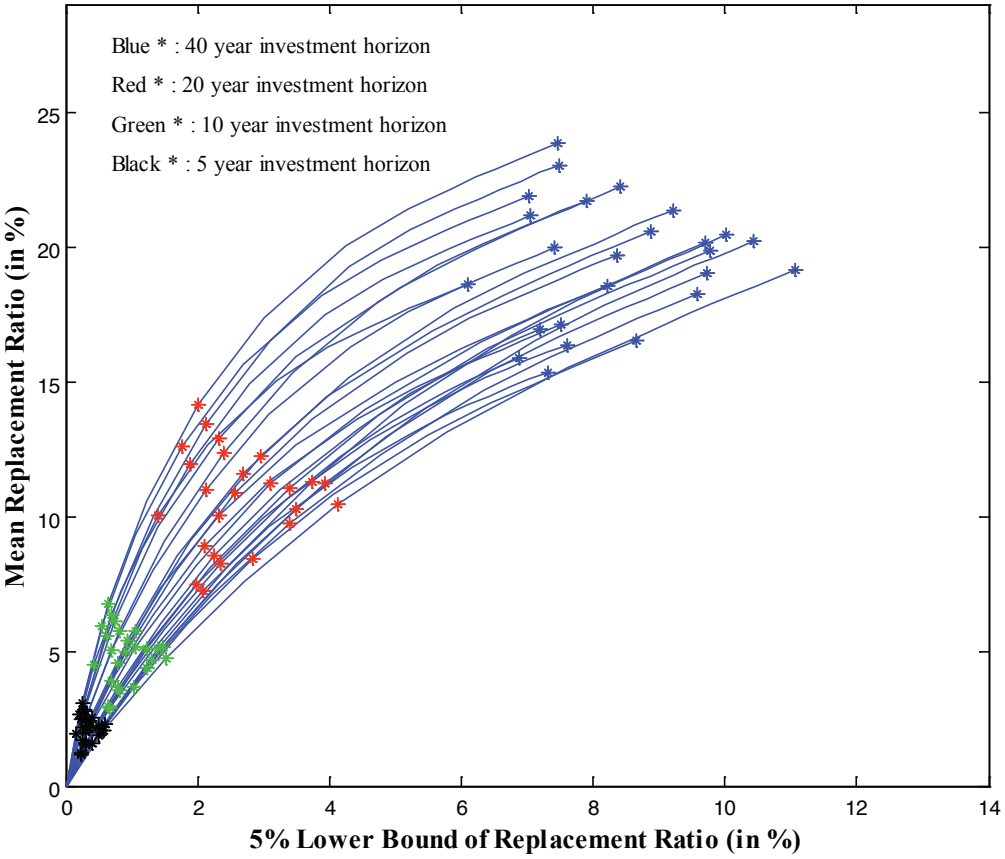
(Switches Schemes)



The bottom line is that an individual in a high-charging older scheme could benefit considerably by switching over to a lower-charging modern scheme. A possible policy implication is that the government might be able to help improve outcomes by taking measures to reduce the barriers against switching over – for example, it might limit or even prohibit exit penalties.

We now turn to our last conceptual experiment which addresses the question: how are outcomes affected if the member invests only for 20, 10 or even 5 years instead of the 40 years assumed hitherto? The results are given in Tables A3.1 to A3.9 (given in Appendix 3) and in Figure 4.

Figure 4: Artillery Barrage Chart



The tables give the exact numbers and also suggest that the rankings are very stable (but not perfectly stable) in the face of changes in the length of the investment horizons. However, Figure 4 gives the easiest-to-digest overall picture. This presents an 'artillery barrage' chart which has some striking results.

The key result is that the longer the investment horizon, the further towards the north east segment of the chart the average member's outcome lies. This is the segment with the highest mean RR and the lowest risk. The chart shows the benefits of investing over long-term horizons. If the member invests for 40 years, his mean RR is between 15% and 25%, and the lower bound is between 6 % and 12%. If he invests for 20 years, his expected replacement ratio varies between about 7.5% and under 15%, and the lower bound varies from under 2% to just over 4%. If he invests for 10 years, his expected replacement ratio varies from 2.5% to a little under 7%, and his lower bound is well under 2%. If he invests for 5 years, his expected replacement ratio is around 2.5% and his lower bound is about 0.5%. Roughly speaking, doubling the length of the investment period (e.g., from 5 to 10, then from 10 to 20 years, etc.) approximately doubles the mean replacement ratio. There is also an approximate square-root rule in operation whereby the mean value of the replacement ratio grows at approximately the square root of the lower bound. Given that the mean RR grows approximately linearly with the investment period, we can then flip this result around: the lower bound grows at approximately the square of the length of the investment period. In plain language, a member who is concerned about his pension tail risk would benefit greatly by investing for a longer period of time. The 'artillery barrage' chart powerfully illustrates the benefits from compounding returns over long investment horizons.

2.5 Summary

We ended *Caveat Venditor* as follows:

> *…. history shows that the UK financial services industry does not readily reform itself. If it fails to respond to our most powerful finding – that high charges have a devastating impact on member outcomes – then auto-enrolment, the flagship innovation for private-sector pension provision, supported by all political parties in the UK, will be a failure.*

We have now provided the detailed quantitative analysis to support this conclusion. In particular, we have the following key findings:

1. The TER is a key determinant of the default fund's outcome, which we express as an income replacement ratio (RR) in retirement. Of the funds modelled, the default fund with highest mean RR (23.8%) was 55% higher than that with the lowest mean RR (15.3%). This was largely due to charge differences. As a rough rule of thumb, each percentage point increase in the TER leads to a fall in the expected replacement ratio at retirement of about 20%, and to a somewhat smaller fall in the lower bound of the projected retirement replacement ratio.

2. While the investment strategy has an important impact on member outcomes, it is much less important than the impact of charges.

3. There is a notable trade-off between risk and return, but it is only the low-charge schemes that lie along the investible frontier. In other words, while 'cheapest' is not synonymous with 'best', there is no evidence that higher charges can 'buy' more sophisticated investment strategies that deliver superior performance.

4. Two types of fund tend to deliver above-average outcomes relative to contributions paid: single trust-based schemes, designed by fee-based consultants for large employers; and modern trust-based multi-employer schemes.

5. Individuals in high charging schemes could benefit considerably from switching to low charging schemes, unless 'exit penalties' are prohibitive.

6. Longer investment horizons generally deliver better average outcomes with lower risk. Roughly speaking, doubling the length of the investment period (e.g., from 5 to 10, then from 10 to 20 years, etc.) approximately doubles the mean replacement ratio. The lower bound grows at only the square root of the length of the investment period, approximately. In other words, VfM increases the longer the member remains invested (so long as charges are competitive).

The findings in this report reinforce the importance of some of the key the recommendations we made in *Caveat Venditor* (see Appendix 1).

Conclusions

The government has introduced auto-enrolment as a policy measure, but it is relying on the private sector to deliver it. During the early years of designing the auto-enrolment system, most traditional providers – the life offices – said that they would not cater for uneconomic employer and workforce profiles. To overcome these problems, the government introduced NEST, which has a public service obligation to accept all employers, irrespective of their economic profile.

Ironically, since then private sector providers – old and new – have said that they will compete in NEST's market, which has led to the launch of several multi-employer schemes that will serve most and sometimes even all employers, but which do not have the public service obligation. Also since then, the life offices have recognised that their traditional employer underwriting techniques – whereby the member charge is inversely related to both the member's contribution level and the sustainability of contributions over the longer term – is anachronistic under auto-enrolment. At least one major life office has introduced a member charge of 0.5% a year for all employers, although admittedly it is difficult to determine the extent to which it might also 'screen out' uneconomic employers, via employer fees, minimum contribution levels etc.

For decades, providers have benefited from the endorsement of employers that promote workplace DC schemes (via bulk sales). They have also benefited from the substantial tax relief on member and employer contributions, which often has been eaten up by member charges. Under auto-enrolment, these providers no longer have to 'sell' pensions to employees in the private sector, because the system brings employers – and therefore their employees – to the providers' door. However, it is clear from research published by the Pensions Institute, the OFT and the DWP, among others, that most of these employers do not have the knowledge and understanding to negotiate a good contract on behalf of scheme members.

We recognise that the government faces a considerable challenge. It is within its gift to change policy and regulation. It is not within its gift to force private sector providers to participate in a market they find uneconomic, particularly when the rules keep changing. The 'ready, fire, aim' approach the government has taken to pension reform means that thousands of employers will have reached their staging date in 2014 and chosen a scheme before further reform is written into legislation.

Nevertheless, the government should have confidence in its ability to promote low-cost schemes where the governance is fully aligned with the members' interests. It should also have the confidence to clean up the legacy DC market, so that the whole of a member's accumulation fund is in a modern-style scheme with low charges. Such requirements will lead to major and rapid changes in the industry, which must be overseen judiciously to avoid market instability.

Above all, both the industry and the government must promote the objective of value-for-money for all schemes involved in auto-enrolment. This is urgent for the reasons set out in this report – and all the more so given that SMEs are due to auto-enrol in 2014-15 and micro employers thereafter. Ultimately, the success of auto-enrolment will be measured by members' trust in the system to deliver value for money. The government, the regulators and the industry must not betray their trust.

Appendix 1: Pensions Institute findings and recommendations in *Caveat Venditor,* October 2012

Findings

1. Our investigation of pension providers, consultants and advisers reveals a dysfunctional market that can lead to severe member detriment, especially for employees in smaller companies.

2. Data on workplace DC schemes are unreliable because contract-based providers re-categorise scheme leavers as retail customers - that is, they are no longer part of the scheme. This makes it impossible to analyse what happens to 'deferred' member charges.

3. Thousands of employees pay six times the annual charge that is available from the modern multi-employer schemes – a total expense ratio (TER) of up to 3% p.a., or even more, compared with a long-term TER of 0.5% or less for these new schemes.

4. For a number of providers, there is a lack of clarity over charges and what precisely is included in the TER. Our research encountered examples of what can only be at best described as 'disingenuous practices' in respect of charge and cost disclosure on the part of some providers and advisers. These unfairly distort competition and strongly influence the 'choice' of schemes employers purchase.

5. Our findings from the quantitative analysis show that the retirement incomes of these in the high-charging schemes will be worth only about an average of 50% of the income achieved by members in low-charging schemes after 40 years of membership.

6. Our quantitative analysis also showed the default funds used for auto-enrolment had very different risk and return profiles, with the highest-risk funds producing around 50% of the retirement income produced by the lowest-risk funds in the worst-case scenarios that we modelled, according to the downside risk measure we used.

7. High charges are disguised by massive complexity, but also by the Financial Services Authority[47] (FSA) projection rates, which are unrealistically optimistic relative to performance post-2000 and are likely to remain so even when revised.

8. Unless older high-charging schemes are abolished, their use for auto-enrolment – when up to 10m low- to median-earners often with low financial literacy join DC schemes – will lead to the UK pensions market facing a mis-selling scandal on an unprecedented scale.

9. The long-term TERs of 0.5% or less for new schemes are the charges that members will pay if they remain in the scheme for a long period of time (at least 7-15 years). If they only stay for a short period, the effective charges they will pay will be much higher in schemes with a dual charging structure (e.g., in the case where the scheme has a charge on both contributions/administration and assets under management).

47 Now replaced by the Financial Conduct Authority (FCA).

10. The extent of vested interest as well as the embedded behaviour or conduct of market participants suggests that the market will not reform itself in relation to older contract-based fund charges.

11. Charges are not regulated by the FSA or the Pensions Regulator (tPR); charges do not appear to form part of the qualifying scheme compliance process.

12. Advice to employers is not regulated by the FSA and tPR. This is a massive oversight on the part of the regulatory system:

- Caveat emptor and the FSA's 'treating customers fairly' (TCF) regime assume that buyers understand the cost of their purchases. This is not the case, especially for smaller employers.
- Auto-enrolees are the customers but they are not the buyers because they are auto-enrolled into a scheme bought by an employer that might not understand the impact of charges. Auto-enrolees, therefore, are 'buying blind'.

13. Large employers with professional advice have the scale and negotiating power to drive down charges. The same is true of the new trust-based multi-employer schemes. Smaller employers are disadvantaged by the supply and distribution system:

- Those with high staff turnover and a significant proportion of lower earners do not have access to professional advice. They are perceived as unprofitable ('polluted' in the industry's language) by most advisers and life offices.
- If these employers happen to find their way to one of the new low-cost multi-employer schemes, members are likely to end up with a bigger pension relative to contributions compared with employees in existing high-charging life office funds.
- However, there is no automatic default position for these employers that directs them to the most appropriate schemes. Under the original blueprint for auto-enrolment, this would have been the government-sponsored NEST, but industry pressure stopped this.

14. Even where employees are auto-enrolled into a low-charging scheme for future service, their older pension assets will continue to languish in high-charging funds due to a dysfunctional transfer market for contract-based schemes:

- Exit charges act as a massive barrier to transfers, which means that members are trapped and frequently pay even higher charges when they stop contributions.
- 'Schemes' are in fact a series of individual contracts. This means that every member has to sign a transfer form – an extensive exercise that requires considerable communication and information resources, which smaller employers in particular do not have.

In the light of these findings, we made the following recommendations in the report.

Recommendations

1. The 'caveat venditor' principle

- Caveat venditor – let the seller beware – represents a more appropriate principle than caveat emptor – let the buyer beware – for members of auto-enrolment DC default funds and should be the overarching framework for auto-enrolment.
- This requires robust governance frameworks that embed a fiduciary duty to put members' interests first.
- Caveat venditor should apply to all schemes irrespective of whether they are trust- or contract-based and whether they are run by providers with shareholders or not-for-profit organisations.

2. There should be a commonly agreed definition of the total expense ratio (TER) (or ongoing charge as it will be known in future).

The TER should include:

- annual management charge (AMC) by the investment manager
- additional fund expenses in relation to specific delegated charges not covered by the AMC (e.g., custodian fees; fund administration fees; accounting and auditing fees; valuation fees; distribution fees; legal and regulatory fees; directors' and advisers' fees)
- all costs relating to scheme administration and member record keeping, whether these be expressed as a monetary or a percentage figure.
- advice to the employer or trustee, where this forms part of the member charge

Any separate advisery fees invoiced by the consultant, but paid for by the employer/trustees rather than the member should be excluded from the TER calculation, because it is too difficult to assess whether the member is being impacted by these fees (for instance via a lower employer contribution rate).

3. The high charges on legacy default funds should be eliminated.

The high charges imposed by the older default funds which started in the 1990s or earlier should be eliminated voluntarily or via regulation.

- The starting point for the Pensions Regulator would be to reject, for scheme qualification purposes, any scheme that has high long-term charges relative to those offered by the new trust-based multi-employer schemes which have an annual long-term TER of 0.5% or less.
- The same point applies to default funds that impose exit charges, as this undermines the portability of member funds and therefore does not reflect the needs of the modern workforce.
- The government and regulators urgently need to consider the solution to member assets trapped in these older schemes due to exit penalties.
- They also need to consider changing the remit of regulators so that they can regulate charges explicitly.

4. A 'scheme' should be a 'scheme', not a series of individual contracts

- The reclassification of contract-based workplace arrangements as 'schemes' would facilitate bulk transfers of members' assets to lower-cost schemes.
- This would also make workplace DC market data more transparent and therefore subject to greater scrutiny.

5. A quality mark should be introduced for schemes that serve the 'direct-to-employer' market and to accommodate 'refugees' from older high-charging schemes

- The current (long-term) TER of 0.5% or less, established by modern multi-employer schemes, would seem to be an appropriate target for the auto-enrolment market as a whole.
- This target should form the basis for a quality mark for schemes that have good investment governance built in, and which can be purchased by employers directly, without the need for advice, which adds to member costs and in the case of smaller employers might not be available.
- Quality-marked schemes should be available via a central website.
- They should be promoted as the natural home for smaller employers in particular that are new to the market, and used for transfers for employers with older high-charging schemes.

6. Regulatory reform

The current dual system of regulation whereby the Pensions Regulator regulates trust-based schemes and the FSA regulates contract-based schemes should be reformed.

7. Advisers to employers should be regulated in the same way as advisers to individuals

- In order to close a loophole that leads to member detriment, the Financial Conduct Authority (FCA) should regulate advice to employers in the same way in which they regulate advice to individuals. Employers – particularly in the smaller company market – cannot be regarded as informed institutional purchasers and their decisions can result in unacceptably high charges for their employees.
- To improve their ability to regulate 'conduct' more effectively, the FCA needs to have a much better understanding of the behavioural traits – identified by us in this report – exhibited by the industry they regulate.

8. Projection rates should be credible

- When the FCA revises its projection rates for DC and other long-term investments, these should be credible and not give the false impression that members can expect a fixed return of 8% (or whatever the new projection rate is).[48]
- Triennial reviews would help to ensure projections remain on track.

48 In November 2012, the FSA announced that the illustrative projection rates would change from 5%, 7% and 9% to 2%, 5% and 8%, respectively. The new rates come into force on 6 April 2014.

9. Projections should be presented in a way that is meaningful to members

Projected outcomes for DC default funds should be presented in a way that is meaningful to members, such as in the form of a projected real income in retirement or a replacement ratio, rather than in the form of a projected return on the fund or a projected fund size at retirement.

10. A measure of downside risk should be presented

Alongside a projected performance measure such as the projected real income in retirement or the replacement ratio, DC default funds should report a downside risk measure

11. The quality of data about the workplace DC market should be improved

There needs to be considerably more high quality data made publicly available about the workplace DC market.

Appendix 2: Schemes considered in the quantitative modelling

This Appendix sets out details of the asset allocations and charges of the schemes considered in the Section 2 of the report.

A2a. Pre-Auto-Enrolment Schemes

The first set of schemes includes those typical of the period before Auto-Enrolment:

1990 Balanced Managed (denoted 1990)

We consider four 1990 vintage schemes: 1990A, 1990B, 1990C and 1990D.

All have the same asset allocation:

- UK equities: 50%
- Overseas equities: 20%
- Fixed income: 20%
- Cash: 10%

Where the scheme employs de-risking, the terminal asset allocation is assumed to be 75% long-dated bonds/ 25% cash (i.e., the scheme is funding for an annuity plus a 25% tax-free lump sum).

The funds differ as follows:

- Fund A involves no de-risking, and a charge of 1.5% of AUM a year throughout (1990A)
- Fund B involves a 3-year de-risking glide path, and a charge of 1.5% of AUM a year throughout (1990B).
- Fund C involves no de-risking, and a charge of 3% of AUM a year for 20 years, then 1.5% of AUM a year for the remaining 20 years (1990C).
- Fund D involves a 3-year de-risking glide path, and a charge of 3% of AUM a year for 20 years, then 1.5% of AUM a year for the remaining 20 years (1990D).

Mid-2000s 100% Equity (2000EQ)

Asset allocation:

- UK equities: 60%
- Overseas equities: 40%

De-risking: a 5-year linear glide path, with a terminal asset allocation of 75% long-dated bonds / 25% cash

Total member charge:

- 1.5% of AUM a year over 40 years

A2b. Modern Funds/Schemes

We consider 20 modern funds/schemes:

2012 Balanced Managed (2012BM)

These modern balanced managed funds are offered by insurance companies and by asset managers via insurers' platforms.

Asset allocation:

- UK equities: 44%
- Overseas equities: 36%
- Bonds: 12%
- Cash: 8%

De-risking: a 7-year linear glide path, with a terminal asset allocation of 75% long-dated bonds / 25% cash

Total expense ratio (TER):

- 0.7% of AUM a year
- 1.4% of AUM a year

This combination leads to the following two defaults:

- Balanced managed with a TER of 0.7% of AUM a year, and a 7-year linear glide path (2012BMA)
- Balanced managed with a TER of 1.4% of AUM a year, and a 7-year linear glide path (2012BMB)

2012 Diversified Growth (2012DG)

Diversified growth funds are offered by insurance companies and asset managers. They can be used as a single default fund option, but are more frequently used as part of a multi-asset default fund strategy constructed for trustees and employers.

Asset allocation:

- UK equities: 22%
- Overseas equities: 32%
- Bonds: 22%
- Cash: 12%
- Property: 3%
- Other (commodities, hedge funds, private equity): 9%

De-risking: a 7-year linear glide path, with a terminal asset allocation of 75% long-dated bonds / 25% cash

TER:

- 0.7% of AUM
- 1.4% of AUM

This combination leads to the following two default funds:

- Diversified growth with a TER of 0.7% of AUM a year, a 7-year linear glide path (2012DGA)
- Diversified growth with a TER of 1.4% of AUM a year, a 7-year linear glide path (2012DGB)

2012 Consultant (2012C)

We consider three different consultant schemes that differ in their asset allocation strategies. The details were provided to us on a confidential basis. For each, scheme, we consider annual TERs of 0.3% and 0.7%. This gives us six combinations:

- TER of 0.3% of AUM a year (2012C1A)
- TER of 0.7% of AUM a year (2012C1B)
- TER of 0.3% of AUM a year (2012C2A)
- TER of 0.7% of AUM a year (2012C2B)
- TER of 0.3% of AUM a year (2012C3A)
- TER of 0.7% of AUM a year (2012C3B)

2013 Multi-Employer Trust Schemes (2013ME)

We consider 10 different multi-employer trust schemes labelled ME1 to ME10 from seven providers. Their asset allocation strategies typically involve dynamic age-dependent allocations. In most cases, the details of these asset allocations were provided to us on a confidential basis. These schemes involve AUM charges varying from 0.3% to 1.0% of AUM a year, and some also include contribution charges and/or fixed annual charges. The sets of charges for each scheme are shown in Table A2.1. The order in which these schemes are shown does not correspond to the ordering of their labels 2013ME1 to 2013ME10 in the charts and figures. While the NEST scheme and the two Now: Pensions schemes (with de-risking glide paths of 5 and 15 years, respectively) can be identified from Table A2.1, this information is not sufficient to identify them in the tables and figures in the main report. Further details are withheld due to the need to preserve anonymity.

Table A2.1: Charges on the Multi-Employer Trust Schemes

%AUM	Fixed charge	Contributions charge
0.50%	0	0
0.50%	0	0
1.00%	0	0
0.30%	£18 pa	0
0.30%	£18 pa	0
0.50%	0	0
0.30%	0	1.80%
1.00%	0	0
0.50%	0	0
0.50%	0	0

Appendix 3: Quantitative modelling results for different investment horizons

This Appendix sets out Tables A3.1-A3.9 which give results for investment horizons of 20, 10 and 5 years, respectively. The member is assumed to join the scheme at age 25 and contribute for periods of 20, 10 and 5 years, respectively. At the end of the relevant period, contributions are assumed to cease, but the fund remains invested and standard charges are extracted until age 65, at which point a lifetime inflation-linked annuity is purchased.

Table A3.1: Replacement Ratios after a 20-Year Investment Horizon

Retirement Replacement Ratio (%)

Scheme	Lower bound	Mean
1990A	2.25	8.52
1990B	2.35	8.23
1990C	1.99	7.47
1990D	2.08	7.22
2000EQ	1.4	10.01
2012BMA	2.57	10.85
2012BMB	2.1	8.88
2012DGA	3.48	10.3
2012DGB	2.85	8.43
2012C1A	2.12	13.41
2012C1B	1.88	11.96
2012C2A	2.4	12.34
2012C2B	2.13	11
2012C3A	2	14.14
2012C3B	1.77	12.61
2013ME1	3.09	11.2
2013ME2	3.39	11.03
2013ME3	2.32	12.91
2013ME4	2.69	11.61
2013ME5	2.33	10.06
2013ME6	3.93	11.23
2013ME7	3.39	9.732
2013ME8	2.96	12.25
2013ME9	4.13	10.45
2013ME10	3.73	11.26

Table A3.2: Ranking by Replacement Ratio Lower Bound after a 20-Year Investment Horizon

Scheme	Ranking
2013ME9	1
2013ME6	2
2013ME10	3
2012DGA	4
2013ME7	5
2013ME2	6
2013ME1	7
2013ME8	8
2012DGB	9
2013ME4	10
2012BMA	11
2012C2A	12
1990B	13
2013ME5	14
2013ME3	15
1990A	16
2012C2B	17
2012C1A	18
2012BMB	19
1990D	20
2012C3A	21
1990C	22
2012C1B	23
2012C3B	24
2000EQ	25

Table A3.3: Ranking by Replacement Ratio Mean after a 20-Year Investment Horizon

Scheme	Ranking
2012C3A	1
2012C1A	2
2013ME3	3
2012C3B	4
2012C2A	5
2013ME8	6
2012C1B	7
2013ME4	8
2013ME10	9
2013ME6	10
2013ME1	11
2013ME2	12
2012C2B	13
2012BMA	14
2013ME9	15
2012DGA	16
2013ME5	17
2000EQ	18
2013ME7	19
2012BMB	20
1990A	21
2012DGB	22
1990B	23
1990C	24
1990D	25

Table A3.4: Replacement Ratios after a 10-Year Investment Horizon

Retirement Replacement Ratio (%)

Scheme	Lower bound	Mean
1990A	0.79	3.67
1990B	0.83	3.55
1990C	0.63	2.97
1990D	0.66	2.86
2000EQ	0.43	4.51
2012BMA	0.90	4.96
2012BMB	0.70	3.92
2012DGA	1.31	4.66
2012DGB	1.02	3.68
2012C1A	0.70	6.34
2012C1B	0.61	5.55
2012C2A	0.81	5.75
2012C2B	0.7	5.02
2012C3A	0.64	6.79
2012C3B	0.56	5.94
2013ME1	1.06	5.14
2013ME2	1.23	5.09
2013ME3	0.74	6.12
2013ME4	0.94	5.41
2013ME5	0.78	4.57
2013ME6	1.47	5.16
2013ME7	1.23	4.36
2013ME8	1.05	5.75
2013ME9	1.52	4.74
2013ME10	1.39	5.11

Table A3.5: Ranking by Replacement Ratio Lower Bound after a 10-Year Investment Horizon

Scheme	Ranking
2013ME9	1
2013ME6	2
2013ME10	3
2012DGA	4
2013ME7	5
2013ME2	6
2013ME1	7
2013ME8	8
2012DGB	9
2013ME4	10
2012BMA	11
1990B	12
2012C2A	13
1990A	14
2013ME5	15
2013ME3	16
2012BMB	17
2012C1A	18
2012C2B	19
1990D	20
2012C3A	21
1990C	22
2012C1B	23
2012C3B	24
2000EQ	25

Table A3.6: Ranking by Replacement Ratio Mean after a 10-Year Investment Horizon

Scheme	Ranking
2012C3A	1
2012C1A	2
2013ME3	3
2012C3B	4
2013ME8	5
2012C2A	6
2012C1B	7
2013ME4	8
2013ME6	9
2013ME1	10
2013ME10	11
2013ME2	12
2012C2B	13
2012BMA	14
2013ME9	15
2012DGA	16
2013ME5	17
2000EQ	18
2013ME7	19
2012BMB	20
2012DGB	21
1990A	22
1990B	23
1990C	24
1990D	25

Table A3.7: Replacement Ratios after a 5-Year Investment Horizon

Retirement Replacement Ratio (%)

Scheme	Lower bound	Mean
1990A	0.31	1.56
1990B	0.31	1.51
1990C	0.23	1.21
1990D	0.24	1.17
2000EQ	0.16	1.96
2012BMA	0.35	2.18
2012BMB	0.27	1.69
2012DGA	0.52	2.03
2012DGB	0.40	1.57
2012C1A	0.27	2.84
2012C1B	0.23	2.46
2012C2A	0.31	2.55
2012C2B	0.27	2.20
2012C3A	0.25	3.06
2012C3B	0.21	2.65
2013ME1	0.38	2.23
2013ME2	0.49	2.24
2013ME3	0.28	2.74
2013ME4	0.36	2.40
2013ME5	0.30	2.00
2013ME6	0.59	2.27
2013ME7	0.49	1.89
2013ME8	0.40	2.56
2013ME9	0.58	2.04
2013ME10	0.54	2.20

Table A3.8: Ranking by Replacement Ratio Lower Bound after a 5-Year Investment Horizon

Scheme	Ranking
2013ME6	1
2013ME9	2
2013ME10	3
2012DGA	4
2013ME2	5
2013ME7	6
2013ME8	7
2012DGB	8
2013ME1	9
2013ME4	10
2012BMA	11
1990B	12
2012C2A	13
1990A	14
2013ME5	15
2013ME3	16
2012C1A	17
2012C2B	18
2012BMB	19
2012C3A	20
1990D	21
1990C	22
2012C1B	23
2012C3B	24
2000EQ	25

Table A3.9: Ranking by Replacement Ratio Mean after a 5-Year Investment Horizon

Scheme	Ranking
2012C3A	1
2012C1A	2
2013ME3	3
2012C3B	4
2013ME8	5
2012C2A	6
2012C1B	7
2013ME4	8
2013ME6	9
2013ME2	10
2013ME1	11
2012C2B	12
2013ME10	13
2012BMA	14
2013ME9	15
2012DGA	16
2013ME5	17
2000EQ	18
2013ME7	19
2012BMB	20
2012DGB	21
1990A	22
1990B	23
1990C	24
1990D	25

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First Actuarial
Hymans Robertson
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Jaitly LLP
Jargonfree Benefits
Lane Clark & Peacock
The Law Commission
Law Debenture
Legal & General
LGIM
NEST Corporation
National Association of Pension Funds
NOW: Pensions
Office of Fair Trading
Office of Greg McClymont, Shadow Pensions Minister
Office for National Statistics
Pension Playpen
Pinsent Masons
Royal London
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Towers Watson
Which?

Acknowledgements concerning the quantitative modelling

Long-term capital market assumptions for the individual asset classes were provided RiskLab GmbH (RiskLab).

RiskLab is the investment and risk solutions adviser of Allianz Global Investors (Allianz GI) and is part of Allianz GI´s global solutions organization.

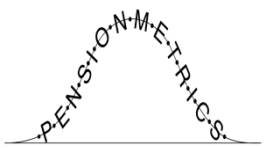
RiskLab provides its services to renowned national and international institutional investors such as pension funds, corporate clients, family offices, wealth managers, and mutual funds.

Allianz GI is the investment arm of Allianz SE, a multi-national financial services company.

RiskLab cannot and does not guarantee the accuracy, validity, timeliness or completeness of any information, calculation, or data made available in the study presented.

We are extremely grateful to RiskLab for providing these data.

PensionMetrics:
The Optimal Design of Defined Contribution Pension Plans



PensionMetrics is a software tool that can be used to design the best defined contribution pension plan for a plan member. For a given set of risk factors, a stochastic simulation model is used to determine the likely outcomes of the pension in retirement for different contribution rates, investment strategies and retirement ages. The model takes account of all relevant member characteristics including age, gender, occupation, prospective retirement age, other savings and investments, and longevity. The model can also take account of factors relating to the plan member's spouse such as age and occupation.

The key risk factors in the model are:

- Salary risk: uncertain future salary, which affects the contributions into the pension fund.
- Investment risks: those risks associated with uncertain investment returns in the pension fund.
- Interest rate risk, which affects both investment risks and the annuity rate at retirement.
- Inflation risk.
- Unemployment risk.
- Longevity risk: the risk of an uncertain future lifetime.

PensionMetrics has the following unique features:

- Fully integrates the accumulation and decumulation phases of a DC pension plan.
- Recognises the importance of taking account of the member's occupation and gender.
- Allows for a wide variety of accumulation phase or investment strategies.
- Allows for a wide variety of decumulation phase or post-retirement strategies.
- Allows for longevity risk.
- Uses fan charts to illustrate the range of possible outcomes.

For more information, please contact David Blake on d.blake@city.ac.uk

Sponsor Statement by B&CE, provider of The People's Pension

B&CE, provider of The People's Pension, is pleased to support this Pensions Institute 'Value for Money' report.

About B&CE

From an aspirational concept in 1942, B&CE has been providing financial benefits for construction workers for 70 years.

With over 30 years of pension scheme experience, and unrivalled expertise in delivering pensions to low-to-moderate earning transient workers, we have harnessed this to develop a compelling automatic enrolment proposition in The People's Pension. With no shareholders, B&CE operates on a not-for-profit basis for the benefit of our members and their beneficiaries.

The People's Pension is suitable for any organisation or employer, large or small, in any sector. It is built on the three key principles: Design Simplicity, Employer Assistance and Employee Engagement.

Value for money

Pension schemes should be run in the interests of the member. Strong governance, simplicity and transparency are all pre-requisites to securing good member outcomes.

While charges are a key determining factor in the value for money equation, we also need to look at the benefits and service provided by the scheme. This can only be assessed when you have simple and transparent charges, so schemes can be compared on the basis of a common currency. This will ensure:
i) employers and members can make easy comparisons; and
ii) providers can compete on scheme quality and cost.

The recommendations highlighted in this report are a significant contribution to the debate in improving the understanding, and delivery, of value for money in pensions. The recommendation that regulatory reform is needed is a strong one. But this is more than just having a single pensions regulator. We need an independent oversight body, an Office for Pension Responsibility, that has the objective of improving the functioning of the pensions market by driving up scheme quality and ensuring fair competition between all market players. The challenges of bringing in an extra 5-9 million people into pensions for the first time through automatic enrolment, the weakness of the 'buy side' (as highlighted in the recent Office of Fair Trading report) and the regulatory confusion caused by having two regulators, all mean that the Government needs to act now to ensure there is proper regulatory and market oversight. To be effective, such an organisation would need to sit separate from, and be truly independent of, the Department for Work and Pensions' policy activities.

We look forward to continue working with the Pensions Institute, with the aim of improving workplace pensions for all savers.

Jamie Fiveash, The People's Pension, January 2014

Sponsor Statement by Hymans Robertson

HYMANS ROBERTSON

We are pleased to support this report, the publication of which couldn't be timelier. Policymakers are seeking to improve the current DC environment for the benefit of all members and of course this should be welcomed. Thus far, the debate has focussed on the level of member charges. This is a complex issue and the Pensions Institute presents an intelligent methodology to determine Value for Money for DC members. The pensions industry is riddled with vested and conflicted interests and the Pensions Institute presents a refreshing independent perspective.

The five recommendations of this report highlight the range of design and infrastructure changes required to improve member outcomes. Of course, changes to the delivery infrastructure alone, such as member charges, won't deliver the supportive structure required to support individuals to achieving an appropriate income in retirement.

Currently, the management of DC plans is the responsibility of the individual. The reality is that the majority of individuals are ill-equipped to do this and attempts to foster a "DIY" approach are unlikely in the majority of cases to succeed. Most people aren't able to manage their pension effectively and don't engage with it. Our belief is that DC schemes should implement a change of direction, accepting that members need and would highly value more support. The solution should embrace the power of inertia through the scheme design and the methods adopted to engage should seek to enforce the right behaviour. This design should focus on appropriate income replacement rates and how to support members to achieve these. This point is highlighted by the Pensions Institute in the second of its recommendations.

Hymans Robertson looks forward to supporting the publication of this report.

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January 2014

Sponsor Statement by NEST

Automatic enrolment represents a huge opportunity to re-build the public's trust in financial services. Providing value for money that stands up to scrutiny is a vital part of laying new foundations with consumers, which is why NEST is pleased to be involved in developing this report.

NEST is a defined contribution pension scheme that UK employers can use to meet their new legal duties. It's an easy-to-use, low-charge scheme that has a public service obligation to accept employers of any size or sector that want to use it.

Our scheme is just part of the new pensions landscape where saving for retirement is no longer a predominantly voluntary pursuit, and the profile of those saving for their retirement is changing radically. Against this backdrop of millions of people new to saving and investing, there is significant responsibility to ensure the interests and expectations of those involved in any element of selecting, advising, governing or implementing schemes are not at odds with those of the end saver.

The norms associated with traditional pension saving are doubtless changing. In particular, we support this report's challenge to the long-held suggestion by certain elements of the investment chain that savers always get what they pay for - that is, that better outcomes are the inevitable outcome of higher charging schemes. There is a greater appreciation in today's world that both the opposite is more likely to be true and also that schemes, including NEST, designed to help employers meet their new duties under automatic enrolment can deliver high quality, well-diversified and carefully risk-managed defaults, as well as additional fund choices, at low cost.

There is also a widening recognition that low cost does not simply mean low AMC or equivalent. Smart delivery that works to reduce the potential drag on performance of investment costs that are typically hidden from savers is a vital part of the value for money, aligning interests and re-building trust enterprise.

For NEST's part, the delivery structure of our default range of 47 single-year target date funds, the NEST Retirement Date Funds, creates a de facto internal market. This allows us to reduce the drag on performance caused by transaction costs.

NEST is among the many schemes working hard to deliver genuine value for money and evolve our offer to savers in order to secure better outcomes over many generations, and play our part in earning and retaining the trust of savers.

Mark Fawcett, NEST CIO,
January 2014

Sponsor Statement by NOW: Pensions

"Value for money" is a phrase often used in relation to pensions but no work has ever been undertaken to define its meaning.

The VfM report follows on from the Pensions Institute at Cass Business School's *Caveat Venditor* Report in 2012 which NOW: Pensions also sponsored. This was a step-changing report and created debate within the industry on issues that need to be tackled to improve pensions in the UK.

It clearly showed how charges significantly impact the outcome for savers and highlighted the conflict in the buying process in that whilst the employee is ultimately the customer, it is the employer who chooses the pension arrangement and hence is the buyer. Therefore the onus should be on the seller or the scheme provider to take responsibility for ensuring that the scheme delivers.

This report takes the debate further in examining how auto enrolment will change the UK pensions landscape, but most importantly it explores what value for money actually means and how it can be gained for the millions of employees who are being auto enrolled, but who make no decision in the purchase.

When NOW: Pensions entered the UK market in 2011, our overriding aim was to build a proposition that focussed solely on the member – to give people in the UK the pension they deserved. Over the past two years, we have been vocal about the need for standards in the industry to improve and in defining, for the first time, what constitutes value for money for members, this report makes an important contribution both to the industry and the ongoing regulatory debate.

It is apparent that while cost is a key determinant, other elements are of equal importance such as a well-designed default fund, strong governance and a good decumulation service. The report also emphasises how scheme design and communication should focus on the income replacement ratio, rather than simply the size of the pension pot as this is the only meaningful measure of the member outcome.

It is clear that much work remains to be done if the industry is to deliver what it "says on the tin"- ensuring that we provide value for money to members so that they are able to retire on an adequate income.

NOW: Pensions support the recommendations of this report as if all schemes adhered to these principles, we would have a much greater chance of establishing an industry which we can be proud of and that serves the people it is supposed to serve, the members of the pension schemes.

NOW: Pensions,
January 2014

About the Pensions Institute

The objectives of the Pensions Institute are:

- to undertake high quality research in all fields related to pensions
- to communicate the results of that research to the academic and practitioner communities
- to establish an international network of pensions researchers from a variety of disciplines
- to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions. As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to solving the complex problems that arise in this field.

The Pensions Institute undertakes research in a wide range of fields, including:

Pension microeconomics
The economics of individual and corporate pension planning, long-term savings and retirement decisions.

Pension fund management and performance
The investment management and investment performance of occupational and personal pension schemes.

Pension funding and valuations
The actuarial and insurance issues related to pension schemes, including risk management, asset liability management, funding, scheme design, annuities and guarantees.

Pension law and regulation
The legal aspects of pension schemes and pension fund management.

Pension accounting, taxation and administration
The operational aspects of running pension schemes.

Marketing
The practice and ethics of selling group and individual pension products.

Macroeconomics of pensions
The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy (e.g., corporate, public and international sectors).

Public policy
Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastricht Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute may include views on policy but the Pensions Institute itself takes no institutional policy positions. For more details, see: pensions-institute.org

Previous Pension Institute Reports

'Delivering DC? Barriers to participation in the company-sponsored pensions market', by Debbie Harrison, Alistair Byrne, and David Blake, October 2004.

'Pyrrhic Victory? The unintended consequences of the Pensions Act 2004', by Debbie Harrison, Alistair Byrne, Bill Rhodes and David Blake, October 2005.

'Annuities and Accessibility: How the industry can empower consumers to make rational choices', by Debbie Harrison, Alistair Byrne and David Blake, March 2006.

'Dealing with the reluctant investor: Innovation and governance in DC pension investment', by Alistair Byrne, Debbie Harrison and David Blake, April 2007.

'An unreal number: How company pension accounting fosters an illusion of certainty', by David Blake, Zaki Khorasanee, John Pickles and David Tyrrall, January 2008.

'And death shall have no dominion: Life settlements and the ethics of profiting from mortality', by David Blake and Debbie Harrison, July 2008.

'Ending compulsory annuitisation: What are the consequences?', by David Blake, Edmund Cannon and Ian Tonks, July 2010.

'Ending compulsory annuitisation: Quantifying the consequences?', by David Blake, Edmund Cannon and Ian Tonks, September 2010.

'Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware' by Debbie Harrison, David Blake and Kevin Dowd, October 2012.

'An evaluation of investment governance in London Local Government Pension Schemes: A discussion paper for stakeholders to the London Funds', by David Blake and Debbie Harrison, November 2012.

'A healthier way to de-risk:
The introduction of medical underwriting to the defined benefit de-risking market', by David Blake and Debbie Harrison, February 2013.

'Returning to the core: Rediscovering a role for real estate in defined contribution pension schemes' Debbie Harrison, David Blake, Tony Key, October 2013.