

VfM

Assessing value for money in defined contribution default funds

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Agenda

- ❖ 9:00 Welcome
- ❖ 9:10-9:45 Presentation of the report
 - Debbie Harrison & David Blake
- ❖ 9:45-10:30 Panel discussion with sponsors
 - Lee Hollingworth (Hymans Robertson)
 - Chris Daykin (NOW: Pensions)
 - Mark Fawcett (NEST)
 - Darren Philp (B&CE: The People's Pension)
 - Debbie Harrison
- ❖ 10:30 Networking in foyer

Purpose of research

- ❖ What does a 'good' scheme look like for the 90-97% of members who will rely on the default fund?
- ❖ Publication of *Caveat Venditor* in Oct. 2012 drew attention to the impact of high charges and poor investment strategy on the member outcome
- ❖ Member outcome defined as the income replacement ratio (RR), the ratio of pension in first year of retirement to final salary before retirement

Market research findings

- ❖ Market size
- ❖ Impact of consolidation
- ❖ From single to multi-trust schemes
- ❖ 'Cherry picking' undermines SME trust
- ❖ Contract law undermines VfM
- ❖ Members at the end of the supply chain
- ❖ Supply chain imperatives in 2014
- ❖ Disclosure of charges and costs
- ❖ Regulation

Market size

- ❖ We predict that the value of the DC market will grow more than six-fold by 2030:
 - ❖ from £276bn AUM pre-auto-enrolment (2012)
 - ❖ to about £1.7trn

Impact of consolidation

- ❖ Fierce competition to result in the domination of five or six trust-based multi-employer schemes by 2020
- ❖ Rapid consolidation among providers could lead to market instability and the sale of pension books to uncompetitive consolidators
- ❖ Uncertain future in market for many EBCs and in particular formerly commission-based corporate advisers

From single to multi-trust schemes

- ❖ Many single-employer schemes expected to transfer to multi-employer arrangements once employers remove DB liabilities from the balance sheet
- ❖ At this point they will be able to dismantle their DB trustee infrastructure

Cherry-picking undermines SME trust

- ❖ ‘Cherry-picking’: providers take on only the profitable section of a workforce
- ❖ Emerging evidence that this undermines plans of SMEs to use existing scheme provider for the whole workforce
- ❖ Do SMEs *really* benefit from running 2 schemes?

Contract law undermines VfM

- ❖ Contract law is a barrier to efficient switching from old to new schemes
- ❖ A change in contract law is needed to facilitate the mass migration of member assets from old to new schemes
 - Would ensure improved VfM for past and future workplace pension savings

Members at end of the supply chain

- ❖ Member VfM can be distorted by supply-side imperatives that are poorly-aligned with members' interests
- ❖ Research raises questions about providers that offer 'free' services to employers & corporate advisers, where cost is incorporated in member's annual charge

Supply chain imperatives in 2014

- ❖ Many providers to prioritise 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
 - And last, to members, who pay schemes, but have no choice in the design or charges

Disclosure of charges and costs

- ❖ AMC, TER, ongoing charge, etc – all incomplete
- ❖ Good governance impossible if full costs are not known. These include:
 - bid-offer spreads
 - poor market timing of 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
 - FX spreads on currency hedging & other hedging costs

Regulation

- ❖ Increasing calls for single regime
- ❖ Regulatory arbitrage
 - e.g., master trusts
- ❖ Conflicts of interest
 - e.g. vertical integration, consultants as providers
- ❖ Law Commission:

'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.'

Modelling VfM in default funds

- ❖ The importance of the income replacement ratio (RR) as a measure of VfM:
 - for given contributions
- ❖ Charges are a key determinant of RR
 - bigger impact than asset allocation
- ❖ Notable trade-off between risk and return
- ❖ Benefits from switching from high-charging schemes
- ❖ Impact of longer investment horizons

The income replacement ratio

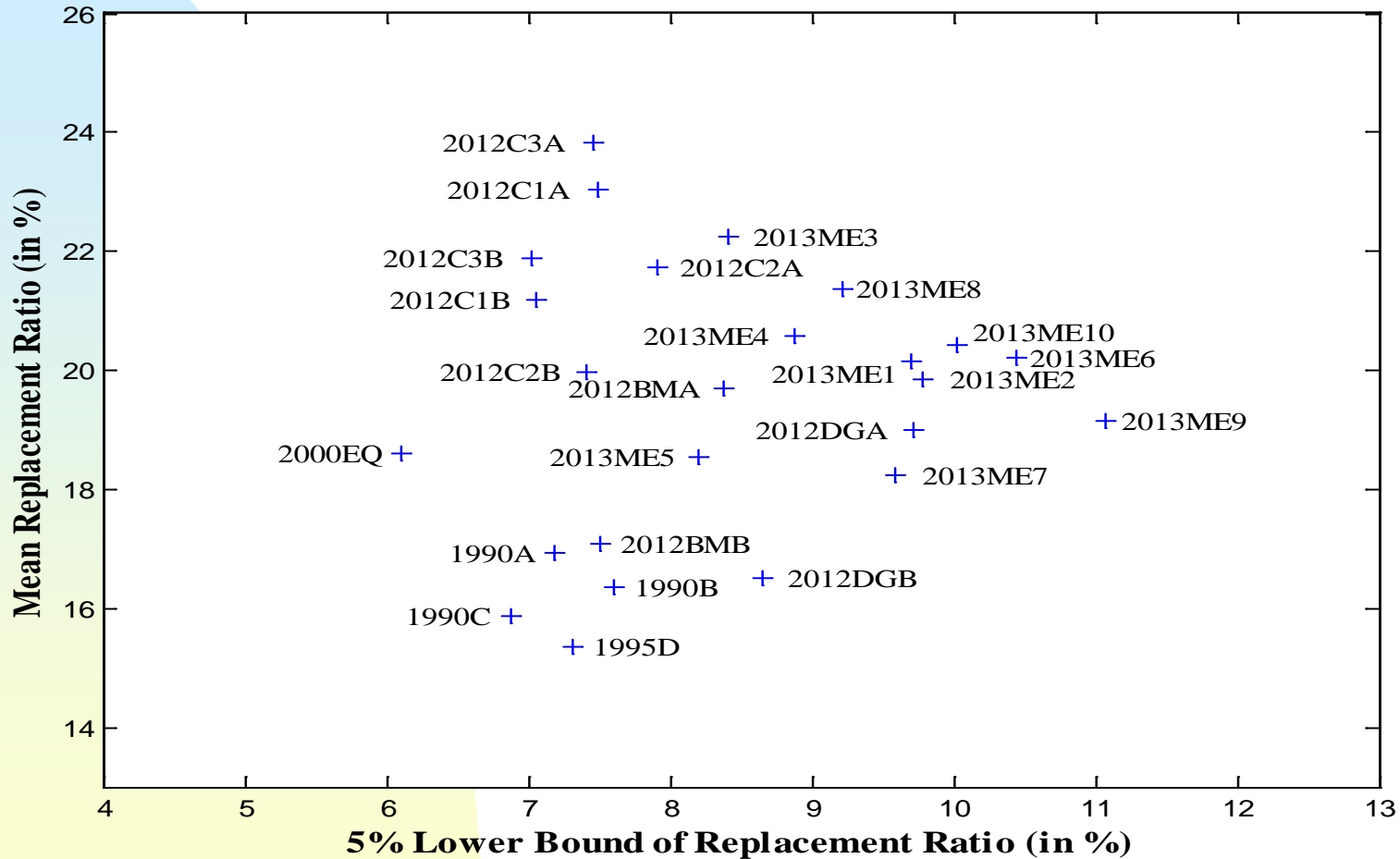
- ❖ The only meaningful measure of outcome is the member's income replacement ratio (RR)
 - ratio of the pension in the first year of retirement to the final salary before retirement
- ❖ The focus on fund size as a target does not take into account annuity-conversion costs:
 - interest rate risk
 - longevity risk

Charges are a key determinant of the default fund's RR

- ❖ We modelled the charges and investment strategies of a representative range of old & new funds
- ❖ 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 guide, each percentage point increase in the TER leads to a fall in the expected replacement ratio at retirement of about 20%

Notable trade-off between risk and return along investible frontier

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

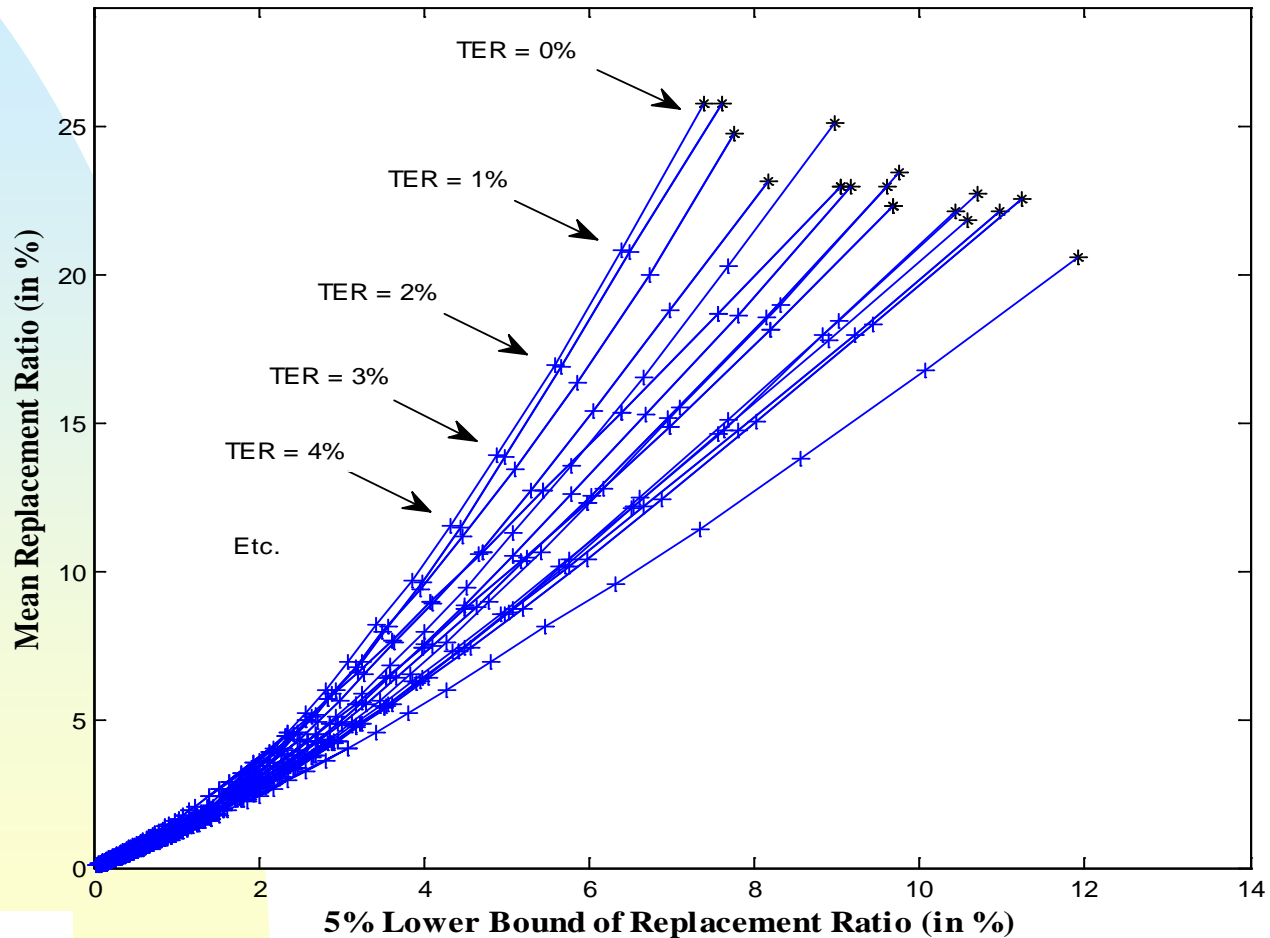


Notable trade-off between risk and return along investible frontier

- ❖ Notable trade-off between risk and return, but only low-charge schemes lie along the investible frontier
- ❖ While 'cheapest' is not synonymous with 'best', there is no evidence that higher charges can 'buy' more sophisticated investment strategies that deliver superior performance
- ❖ Default funds with low charges were consistently amongst the better performers, while default funds with high charges were consistently amongst the worst performers

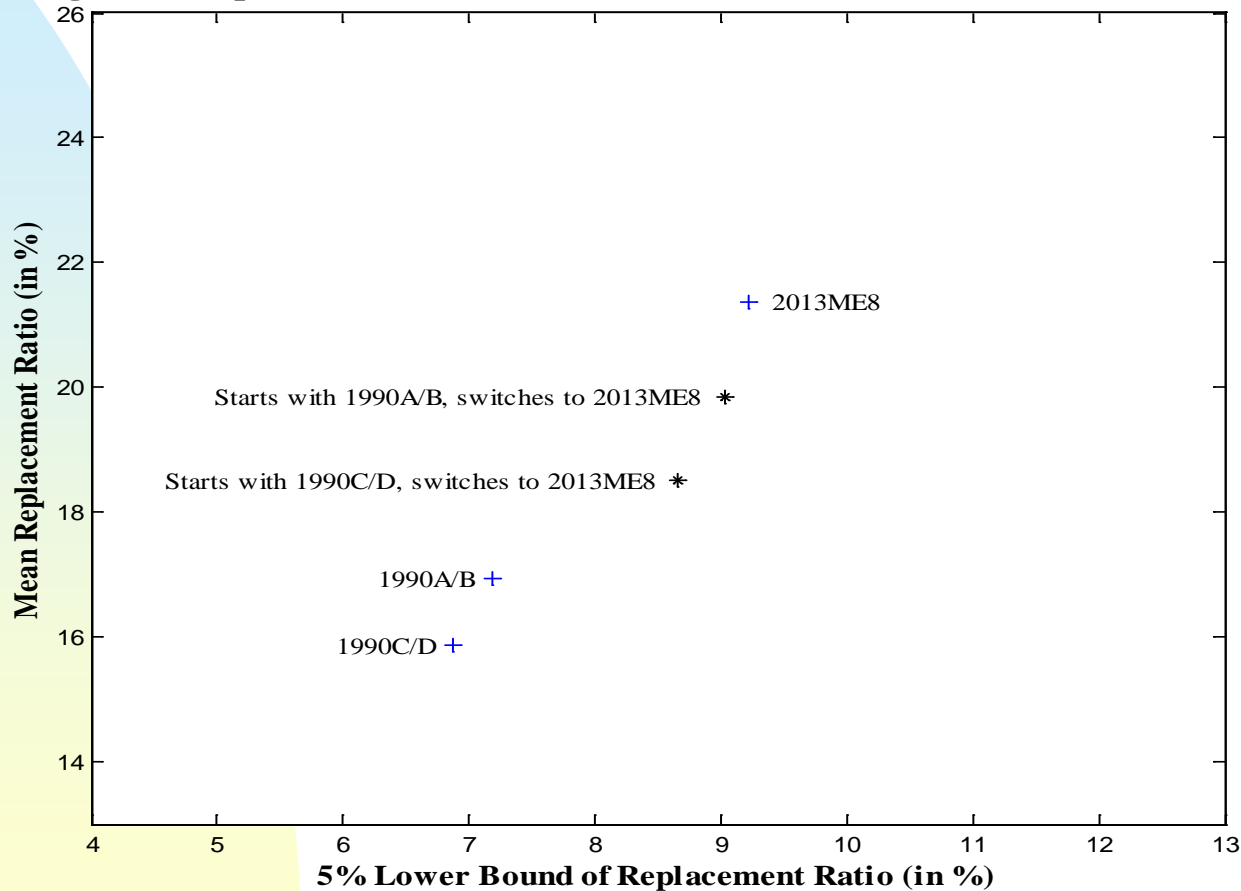
Charges have a bigger impact than asset allocation

Figure 2: Shooting Stars Chart (40 Years Contributions)



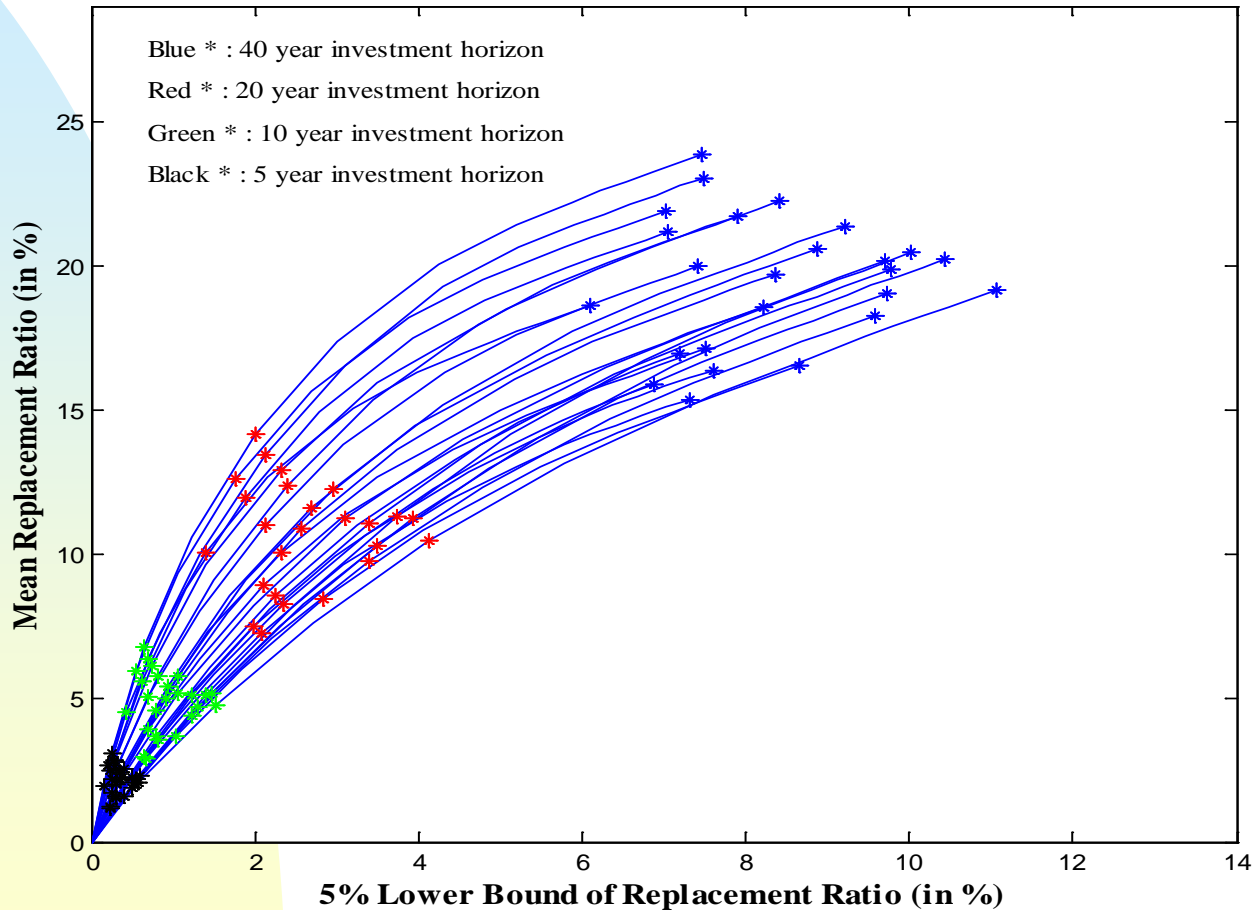
Benefits from switching out of high-charging schemes

Figure 3: Replacement Ratio: Mean vs. 5% Lower Bound (Switches Schemes)



Longer investment horizons generally deliver better average outcomes with lower risk

Figure 4: Artillery Barrage Chart



Impact of longer investment horizons

- ❖ Longer investment horizons generally deliver better average outcomes with lower risk
- ❖ Put simply, doubling the length of the investment period (e.g., from 5 to 10, then from 10 to 20 years, etc.) approximately doubles the mean RR
- ❖ So, VfM increases the longer the member remains invested:
 - provided charges are competitive

Report's recommendations

- ❖ A clear definition of member VfM
- ❖ A clear definition of the member's target outcome in terms of an income RR
- ❖ A clear definition of costs and charges, reported in full
- ❖ Assets in older sub-standard schemes to migrate to new schemes
- ❖ The need for regulatory reform

A clear definition of member VfM

- ❖ VfM for members means the optimal combination of scheme cost and design, sustainable over both the accumulation and decumulation periods. This includes:
 - TER of c.0.5% for the accumulation period
 - well-designed dynamic multi-asset default funds
 - expert independent governance
 - effective member communications
 - efficient consolidation system for transferring from older schemes
 - specialist decumulation service

A clear definition of the member's target outcome in terms of RR

- ❖ The only meaningful expression of the member outcome is the RR
- ❖ There could be a target RR as part of the scheme's funding strategy, delivered by:
 - increasing contributions
 - working longer
 - delaying the decumulation starting point
- ❖ Investment strategy should have a straightforward target:
 - e.g., CPI + X%

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 scheme 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 be published on a central website for independent public scrutiny

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

- ❖ Revision to DC contract law would enable the government and regulators to instigate a mass migration of assets from older schemes with poor investment strategies and excessive charges to modern schemes
- ❖ The process must include all personal pension plans created when members of contract-based schemes leave employment

The need for regulatory reform

- ❖ Report states reform of the two-regulator regime is essential
- ❖ One possibility is for a single regulatory regime:
 - Oversight by OFPEN
 - Transition towards single legal structure for multi-employer schemes:
 - trust-based, but with rigorous overhaul of master trusts

Panel Discussion with Sponsors

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