PRESS RELEASE

DRAFT

Clear understanding of member Value for Money (VfM) critical to success of auto-enrolment

- **DC assets under management expected to grow to £1.7trn by 2030**
- **Rapid consolidation will require government and regulatory oversight**
- **No link between higher charges and better member outcomes**
- **Each percentage point increase in the member charge leads to a fall in the expected pension at retirement of about 20%**

LONDON 16 January 2014: Following the introduction of auto-enrolment, the value of the defined contribution (DC) pensions market is predicted to grow more than six-fold by 2030, from £276bn assets under management (AUM) pre-auto-enrolment (2012) to about £1.7trn. A new report from the Pensions Insitute , *VfM: Assessing value for money in defined contribution default funds*, examines the long-term impact of auto-enrolment on the DC market and sets out recommendations to providers, advisers, government and regulators to ensure member VfM does not suffer as a result of market forces. It also analyses DC scheme default funds, the multi-asset investment strategies designed for the majority of scheme members who do not make investment decisions. For a given level of contributions, differences in explicit and undisclosed member charges, asset allocations, and de-risking glide paths (the changing asset allocation over the period of membership), largely determine the differences in pension income that is secured in retirement, usually by purchasing a lifetime annuity. The report finds that while cheapest is not necessarily best, there is no link between the cost of membership and member outcomes: higher charges are not linked to potential outperformance.

Findings

1. **Market size:** The value of the DC market is predicted to grow more than six-fold by 2030, from £276bn assets under management (AUM) pre-auto-enrolment (2012) to about £1.7trn.

2. **Impact of consolidation:** Fierce competition will result in only five or six major 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. Many employee benefit consultants and corporate advisers face an uncertain future in the market.

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

4. **Cherry-picking undermines trust:** The practice of 'cherry-picking', whereby providers take on only the profitable section of a workforce, scuppers many smaller employers' plans to use an existing scheme provider for the whole workforce.

5. **Contract law changes:** A change in contract law is needed to facilitate the mass migration of member assets from old high-charge schemes to new low-charge schemes, ensuring member VfM for the remainder of the accumulation period. Modelling of a representative range of old and new funds indicates that pensions secured by the best funds are 55% higher than in the worst over a 40-year working life. This was largely due to charge differences. As a guide, each percentage point increase in the member charge leads to a fall in the expected pension at retirement of about 20%.

6. **Members at end of the supply chain:** Member VfM is distorted by supply-side imperatives that are poorly-aligned with members' interests. The research raises questions about providers that offer 'free' services to employers and to corporate advisers, where the cost is incorporated in the member's annual charge. In 2014, many providers will prioritise their services:
    a. First, to the corporate adviser (formerly commission-based, now fee-based), which sells schemes to employers and whose advice in this market is unregulated
    b. Second, to the employer, which acts as the provider's unregulated agent
    c. And last to members, who pay for schemes, but have no choice in the design or charges.

Recommendations

1. **Define member VfM:** VfM for members means delivering the optimal combination of scheme cost and design, sustainable over both the accumulation and decumulation periods. This includes a total expense ratio (TER) in the region of 0.5% for the accumulation period, a well-designed multi-asset default fund with a glide path that is subject to regular modelling scrutiny, strong independent governance, and a low-cost professional decumulation service.

2. **Define 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; the ratio of the pension in the first year of retirement to the final salary before retirement. An outcome expressed in terms of fund size does not take account of the annuity-conversion risks (e.g., interest rate volatility and longevity risk).

3. **Define and require all costs and charges to be 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.

4. **Migrate assets in older sub-standard schemes 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.

5. **Reform regulation:** The auto-enrolment market requires a clear and consistent legal and regulatory regime across contract- and trust-based schemes. Without this reform, regulatory arbitrage will make a mockery of the new pension system for the private sector.

Dr Debbie Harrison, Visiting Professor at the Pensions Institute at Cass Business School, said: "The stakes are high and the battle to secure market share between now and 2018 is going to be bloody. The government and regulators must ensure that in a market where competition is weak, due to the lack of expertise of smaller employers, that the schemes that emerge as victors do so because they offer genuine member value for money. Otherwise there is a danger that deep pockets, predatory pricing and conflicts of interest might become the hallmark of the dominant auto-enrolment schemes."

Darren Philp, Head of Policy, B&CE's The People's Pension, said: "This report isn't the first to call for a single pensions regulator. We need a regulatory framework that protects members, drives up standards and ensures the market works effectively. We would like to see an OFPEN that brings together those involved in regulating workplace pensions and ensures that the market is working effectively and in the interest of savers. Delivering value for money requires transparency. We need an approach that allows employers and employees to be able to compare easily what different schemes cost."

Lee Hollingworth, Partner & Head of DC Consulting, Hymans Robertson, said: "We welcome the Pensions Institute's timely report, which provides a valuable independent review of the DC market and introduces an intelligent methodology to assessing consumer value. Experience has shown us that the majority of DC members will be unable to manage their pension effectively or engage with it in a way that will provide an adequate income in retirement. A step change in DC design and communications is needed to help support members towards a targeted income replacement rate in retirement."

Mark Fawcett, Chief Investment Officer at NEST, said: "With the expected significant growth in the DC pensions market, and as DC becomes the primary source of occupational pension saving in the UK, it is clearly vital that millions of people have access to high quality, good value schemes. These schemes should have the scale to implement innovative risk-managed default investment strategies to deliver consistently good outcomes in line with the best funds highlighted in this report."

Chris Daykin, Trustee Director, NOW: Pensions, said: "Auto enrolment provides a unique opportunity to change the retirement fortunes of millions of people in the UK. But, it is imperative to ensure that the schemes into which employees are enrolled deliver value for money. If the report's recommendations are followed, scheme members can have greater confidence that their pension will deliver a lifetime income in retirement that is fair value relative to the contributions paid. The consequences of ignoring these warnings will be many disappointed pensioners and an ageing population which simply cannot afford to retire."

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Notes to editors

The Pensions Institute at Cass Business School is the first and only independent academic pensions research organization in the UK (http://www.pensions-institute.org/).

VfM: Assessing value for money in defined contribution default funds is available here: http://pensions-institute.org/reports/ValueForMoney.pdf

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