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)

- Starts with 1990A/B, switches to 2013ME8
- Starts with 1990C/D, switches to 2013ME8

Legend:
- 2013ME8
- 1990A/B
- 1990C/D
Longer investment horizons generally deliver better average outcomes with lower risk.

Figure 4: Artillery Barrage Chart

Blue * : 40 year investment horizon
Red * : 20 year investment horizon
Green * : 10 year investment horizon
Black * : 5 year investment horizon

Mean Replacement Ratio (in %)

5% Lower Bound of Replacement Ratio (in %)
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