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# Society of Pension Professionals' response to Improving Outcomes for members of DC pension schemes

We are pleased to respond to this consultation.

## Executive summary

We are pleased the Government has recognised the importance of net returns on member outcomes and consider this to be a welcome evolution of the Government's view which has previously appeared at time to be too focussed on charges and costs. However, as set out below there are some challenges to face in getting this data.

We have some concerns around the £100m threshold, both with its increased level, which schemes will be in scope and the practical implementation of the comparator scheme requirements.

We ask for further clarity on the "look through" statements you have made about the underlying costs in investment funds since we are concerned that there could be seemingly arbitrary differences depending on a fund's structure.

Finally, we welcome the clarification that documents can be published on a series of linked web-pages and also the "tidying-up" changes you propose to various bits of legislation.

## Detailed response

### Chapter 2: Encouraging Consolidation

***Q1: We would welcome your views on the reporting of net returns - how many past years of net returns figures should be taken into consideration and reported on to give an effective indication of past fund performance?***

We welcome the development of disclosure requirements to help members choose between funds offered by a scheme, and to require trustees to assess value for members both at the fund and scheme level. However, we can see considerable practical challenges in the delivery of this requirement.

- **Obtaining the data:** Details of transaction costs continue to be much more difficult to obtain than other charges. Even authorised master trusts still struggle to get the information in a timely manner to give members a properly representative view of costs and charges in the chair's statement. Trustees need to obtain this information from investment managers who may use different time frames on which to report, few will match against specific scheme year ends, and there is also significant variation in how long it takes for the information to come through. As a result, try as trustees might, the chair's statement is inevitably comparing apples with pears. This applies across the spectrum of schemes. Introducing a requirement for pension schemes to report net returns from October 2021 seems premature when there is no consistency required from managers.

The Pensions Regulator has already recognised this challenge: "The law requires trustee boards to calculate at least annually the charges and, **insofar as they are able to, transaction costs** (incurred as a result of buying, selling, lending or borrowing investments), to which members' funds are subject; and to assess the extent to which they represent good value for members."(our emphasis added).
These timing issues do impact the value of the chair's statement to members, but currently do not necessarily impact a trustee's value for member assessment as this occurs over a more fluid timeframe and can flex to cope with delays in data. However, once the net return assessment becomes an annual and fixed process, the difficulties in getting data will have a more extreme impact, and not to the benefit of members.

We would suggest revisiting the timetable for introduction of this requirement, in tandem with tackling the obstacles to getting the information in the first place.

- **Processing the data:** The use of a geometric mean to derive information makes mathematical sense, and tracks the compounded annual growth rate charts that are often made available to savers in authorised retail funds. However, we question how easy this will be to deliver cost-effectively by pension schemes. The impact assessment assumes it will take trustees 15 minutes to set out the information. But this isn't just a case of repeating what the investment manager has provided. We would suggest adding more tangible guidance as to how to do this calculation process if the intention is to help trustees turn this into a simple process.

- **Use of past years:** A five-year period (or how long the fund has been available if shorter) makes good sense in principle. However, we would recommend a transitional period. We understand why the DWP might expect data to be readily available from 2015 onwards, as the obligation to start recording transaction costs was introduced then. But the reality is that the information may not have been delivered in the past in a way that lent itself to the current presentation requirement. It may be necessary to have a transitional period which is less about how long the fund has been available to members and more about over how long the trustee can feasibly source the required data for past years.
We also see difficulties with default funds (and white-labelled funds) which are composites of multiple underlying funds. The individual elements will change over time (quite separately from lifestyling rebalancing at various ages). A five-year report on aggregate net return of the default fund will not tell you anything about the long-term performance of the current elements. If the aim is to equip the member/saver with the information to decide whether to select different funds, this may not be the way to do it.

- **Variable charges:** Master trusts providing different investment options for different client employers will have to show the difference in pricing at a member level where the pricing is actually driven by volume, or complexity of the default investment options required by individual employers. This is likely to become quite a confusing picture for the actual members who do not have the option of moving to another client employer and we question the value. We also ask for further guidance about how you envisage this data is set out since the amount of information now required in the Chair's Statement could lead to confusion and information overload.

***Q2: Do you think that the amending regulations achieve the policy aims of encouraging smaller schemes to consolidate into larger schemes when they do not present optimal value for members?***

We have some concerns that the new requirements for schemes under £100m are too blunt an instrument. There are a number of reasons for this.

- **Omission of DC sections:** It is not fully clear whether the policy intention is to apply these sub-£100m additional requirements to the DC sections of hybrid schemes, or not. The consultation paper generally refers to scheme assets, which would include the assets dedicated to DB liabilities, but in paragraph 74, there is reference to the money purchase assets of a scheme. The amending regulations as drafted would only apply the new requirements to schemes where total assets under management, including DB assets, are under £100m.
We ask because there are many hybrid pension schemes where the DC arrangement is a small and unloved part of a much larger DB scheme which will not be picked by these requirements. With these schemes, even if the overall scheme is large enough to warrant some investment in illiquid assets, the DC assets will be (and must be) managed separately and will not be used in that way.
The trustees of such schemes will be grateful not to have additional DC obligations and, as is noted below, there are peculiar challenges with consolidating these DC add-on sections, but the approach does run counter to the stated policy. It would be helpful to confirm what policy is in this area.
- **Difficulty in making transfers from hybrid schemes:** As the DWP will be aware, there is a very real HMRC barrier to transfers to wind up small DC sections of hybrid schemes. Where a member has grandfathered tax status in a scheme for certain purposes (notably an early minimum pension age for their DB benefits, or a right to a larger lump sum than the currently authorised 25%), those rights will be lost if the member's other small DC pot in the same scheme is transferred out for consolidation purposes. This issue has been present since tax simplification in 2006, and we have seen a considerable number of consolidation exercises being prevented for this reason. We would urge a solution to this barrier.
- **Operating for more than three years:** it is not immediately obvious what "operating" means here. This is not a term which is in common usage in pensions legislation. In context it probably does not, for example, mean it has been registered for three years – a scheme can be registered with HMRC (and indeed authorised as a master trust) without actually having any members. We would recommend greater clarity here.
- **Using up members' pots:** we are concerned that while consolidation may be in the long-term interest of UK plc and members as a whole, the immediate impact of these new requirements will fall directly on current members' pension pots. Where the sponsoring employer is not required to meet administrative costs, the trustees of such schemes will need to charge members' accounts with the cost of going through this comparison exercise. If and when the trustees conclude that the scheme should be wound-up and members transferred, again the cost may have to come from members' accounts and may outweigh the remaining benefit of moving to another scheme with slightly lower transaction charges. There is nothing in the legislation to require sponsoring employers to fund the process. There are also some circumstances where there may not be a sponsoring employer at all, for instance where the employer no longer exists or there never was a legitimate employer, such as scam schemes, where TPR have stepped in to appoint an independent trustee.
- **The best go down first:** There is a risk that the first schemes to be significantly affected will be those with the most conscientious trustees who are already focussed on governance and value for members. The response suggests that there is no great difference between a £10m threshold and a £100m threshold but that is not our experience. We are aware of some excellent middle sized DC schemes which these new requirements may drive into consolidation whereas it may take a number of years for the less conscientious trustees to come to the conclusion that they are not offering value for money.
- **Cost is not the same thing as value:** we would invite the DWP to consider how to shield the more complex schemes which offer legacy saving arrangements no longer available in the market, such as guaranteed annuity rights. The guidance offers ways to value these legacy rights, which is helpful but still requires comparison against very different and much less sophisticated investment options.
- **Annual tests:** we do not see the value to members in annual tests of value to members. We would strongly recommend a triennial approach, but with stronger focus on the results, rather than a gradual erosion of schemes by increasing their costs beyond sustainability. A compromise approach would be to require a "full" test every three years and a simpler review in intervening years to identify

any material changes. A similar model is used for actuarial valuations/ reports or Statements of Investment Principles.

- **Requirement for one comparison scheme to be/appear willing to take a transfer:** our experience is that different authorised master trusts and providers have different appetites for taking on another scheme's members. For some there will be minimum size/volume requirements, others specialise in particular industries, or prefer closed schemes. So, a medium sized scheme will have different options from a tiny scheme. There is also a value judgment which trustees will need to make which is not acknowledged in the legislation or the guidance. For a trustee to select for comparison purposes one of the "less fussy" schemes in the market to tick the "prepared to accept a transfer" has no value to members unless the trustee also considers that that scheme would be a suitable recipient of the liabilities from the members' perspective. We are concerned that the comparator selection process will drive the wrong behaviours.

***Q3: Do you believe that the statutory guidance increases clarity about the minimum expectations on assessing and reporting on value for members for specified schemes? Are there any areas where further clarity might be required?***

The guidance overall is helpful. We have a few comments on certain aspects.

- **Geometric mean**: as discussed above, further explanation is needed of what this is and what it looks like in this context. The guidance, and the Impact Assessment, expect trustees to be able to prepare these tables, but provide no detail on the underlying methodology. The approach should be accessible.
- **Value for members**: we are concerned at the mixed messages in the guidance. The guidance acknowledges that the value of a scheme should be assessed in the round, but the overall focus of the document is on costs and charges. For example in paragraph 109 "where there is a significant difference in the costs and charges that can be achieved in the market … we would expect trustees of smaller schemes to conclude that they are unable to deliver value for members".

This is a very different approach to the Pensions Regulator's own guidance which for example notes in paragraph 116 of its DC Code of Practice: "We expect trustee boards to make efforts to understand the characteristics of their members and, where possible, their preferences and financial needs, and to take this into consideration when exercising their judgement about what represents value for members.". It is very difficult to reconcile that position with one where trustees are invited to compare their schemes specifically against the most different schemes they can find.

We understand that government policy is consolidation, but it must be as important that members understand and connect with their pension savings. That means good quality member interfaces, and a good choice of investment options. As the Regulator has put it: the "combination of costs and what is provided for the costs". Simply focusing on costs will lead a race to the bottom. It may in fact have the opposite effect from that the government seeks, because the cheapest investment options will be those without a sophisticated view of the total investment market.

- **Accessibility of the guidance**: The title of the guidance is potentially misleading. The guidance covers net return calculations which are to apply to all DC schemes, plus the value for members assessment which only applies to specified schemes. However the title focusses exclusively on the latter. We would suggest something like "Defined contribution pension schemes: net returns and value for members".
- **Winding up costs**: the guidance is emphatic that winding up costs should be ignored in assessing value for members. We do not agree with this. Winding up costs and exit charges are an integral part of the decision as to whether the trustees can do better for their members or whether what they have is the best in the circumstances. There is nothing in the legislation to carve out winding up costs from the VFM test and consolidation should not be an aim in its own right at the scheme level.
- **Comparison schemes**: the legislation is not prescriptive in terms of what would make a suitable comparison scheme, except to require one comparison scheme to be willing to take a transfer. The guidance however is highly directional on what comparison schemes should be, and specifically how different they should be. The only stakeholder that wins here is the benefit consultant. We can see an entire new industry arising out of the need for the choice of comparators to be justified, and even a market in finding the most expensive comparator. This is a considerable step forward in complexity from the benchmarking approach currently in use.

**Chapter 3: Diversification, performance fees and the default fund charge cap**

**An in-year adjustment to prorating performance fees**

***Q4: Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?***

We understand this type of performance fee calculation method may not be typical in currently available investment options.

**Creating a multi-year rolling calculation approach**

***Q5: What should we consider to ensure a multi-year approach to calculating performance fees works in practice?***

We will leave it to others who are better placed to answer this.

***Q6: We are proposing a five-year rolling period. Is this appropriate or would another duration be more helpful?***

As for Q5.

***Q7: We are proposing offering a multi-year option as an alternative to an in-year option for schemes. Do you have any suggestions for how to improve this offer?***

As for Q5.

***Q8: To what extent will providing a multi-year smoothing option give DC trustees more confidence to invest in less liquid assets such as venture capital?***

As for Q5.

**Costs of holding physical assets**

***Q9: Do the draft regulations achieve the policy intent? Do you have any comment on the definitions used?***

We do not have any specific comments on the proposed definitions. In relation to the question of "look through", we consider that the Department's statements regarding "look through" remain unclear and impractical in respect of certain investments. For example, we note that the Department's suggested approach could produce seemingly arbitrary results when applied to two substantively similar REIT investments, one of which happens to be classified as a closed ended investment fund and the other as a commercial company.

**Chapter 5. Updates to Statutory Guidance: Reporting costs, charges and other information**

***Q10: Do you believe that the updated statutory guidance increases clarity about the minimum expectations on both the production and publication of costs and charges information? Are there any areas where further clarity might be required?***

We consider that the guidance in relation to the production of costs and charges information is helpful, although we note that producing these illustrations could still be complex for large master trusts with multiple default funds and a range of different charge levels for different participating employers, and taking this approach would seem to be in tension with the policy goal of communicating charges "simply and clearly to members".

We welcome the clarification regarding publication of content across a series of linked documents or pages. Where documents are published across a series of web pages, please confirm that when providing a link in annual benefit statement it is compliant to link to one page from which members can access the other pages.

We would also ask that you reconsider the requirement in the guidance to use the median pot value projected over the timespan until the youngest member in a scheme reaches NPA. This does not make sense and could be misleading. We suggest that a standard amount such as £1,000 is used instead.

**Chapter 6: Other changes to legislation**

***Q11: We propose that where the default arrangement includes a promise, the trustees of the scheme should be required to produce a default SIP. We propose that this should be produced within 3 months of the end of the first scheme year to end after the coming into force date.***
***(a) Do you agree with this policy?***
***(b) Do you agree that the legislation achieves the policy?***

We agree with your proposal that default arrangements including a promise, such as with profits policies, should be required to produce a SIP. We agree the draft legislation (Reg 4(2)) achieves this but request that the timescale for implementation is slightly modified to be "the later of six months after the coming into force date or three months of the end of the first scheme year to end after that date". This is to give schemes whose year-end is, by chance, close to the coming into force date a little bit longer to prepare a document which can take significant time to produce from scratch.

***Q12: We are proposing that, for relevant schemes, charges and transaction costs should be disclosed for any fund which members are (or were) able to select and in which assets relating to members are invested during the scheme year.***
***(a) Do you agree with this policy?***
***(b) Do you agree that the legislation achieves the policy?***

We agree with this policy and that the amended legislation should achieve it. For the avoidance of doubt, you could go further and state the policy intention in DWP guidance.

***Q13: Do you agree with this proposed change? Do you have any other comments on this topic?***

We wrote to you about this issue in September 2019 and are therefore glad to see it being addressed in these amendments. We agree with this proposed change to amend the long-standing exemption for wholly insured schemes to also exclude regulation 2(3)(d).

***SPP response ends***

Yours sincerely

**Tim Box**, Chair, SPP Defined Contribution Committee
**Fred Emden**, SPP CEO

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SPP's Defined Contribution Committee has considered this call for evidence, whose membership includes representatives of consultants, pension administrators, pension lawyers and product providers.