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Value for money in DC workplace pensions

Executive summary

This report was commissioned by Standard Life.

Standard Life

Standard Life Investments

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Executive Summary

Developments in the pensions landscape such as automatic enrolment and the introduction of pension flexibilities have led to a focus on value for money.

To date, regulators and other stakeholders have focused on charge structures, with less attention given to other elements that determine value, such as governance and communication. In turn, there have been discussions within the pensions industry around value for money. This report looks to expand the discussion to include other aspects of value for money by summarising existing research for the different factors, supplemented with PPI modelling results that explore the impact of investment, governance and individuals' choices at retirement.

This report considers the definition of value for money in workplace pensions, including both contract and trust-based pensions, in order to inform the development of Defined Contribution (DC) workplace pension provision. It primarily considers value for money from the member's perspective, although it recognises that pension schemes should also look to provide value to employers.

It may not be possible for IGCs and trustees to attain the best member outcomes for all members, these bodies may be required simply to make decisions that are broadly in members' best interests,

This reflects the fact that value for money varies in line with pension membership. It may be subjective, with two members in identical circumstances having different definitions of value.

However, while there is no single definition of value for money it is possible to identify three outcomes that are likely to be seen as positive for members across the board

These outcomes include:

- Value of the pension pot
- Security of the pension pot
- Trust in the pension scheme

These factors are used in the remainder of the summary and report as outcome measures.

A range of factors influence value for money in different ways

Pension scheme characteristics affect outcomes in different ways with each of these offering scope for attention and debate by the pensions industry. Charge levels and structures, investment returns, and contribution rates have a direct impact on outcomes, in monetary terms, as they affect the value of the pension pot. However, other areas such as governance, administration and communication are important in terms of sustaining members' trust and ensuring that the outcomes meet members' needs.

In practice, good governance can be the lynchpin for driving better value for money and, where this is absent, this could lead to significantly poorer outcomes for members

Good governance can help:

- Communicate the importance of contribution rates
- Ensure that there is transparency around areas such as charges
- Set the right default investment strategy for the membership (considering for example, appropriate levels of risk, return and volatility), monitor it, and then take timely and appropriate action to change it if necessary
- Ensure effective administration
- Ensure member communications are in the right form set at the right level of understanding and frequency, and that they increase member engagement, and drive good member decisions.
- Challenge, negotiate and possibly lower charges

Where the absence of effective governance leads to the mismanagement of investments or the absence of internal controls, this can lead to significantly lower value of pension assets.

Effective communication strategies can influence outcomes by leading to higher employee contributions

Some approaches used to date have been employee engagement or based on ‘nudge’ where inertia leads employees to follow a particular course of action, or a combination of these. Specific examples including automatic escalation can lead to higher contributions and have been popular with both employers and employees where survey research has explored these.

Final retirement outcomes in terms of pension pot value are largely driven by contributions

An increase in contributions from 8% to 9% or under automatic escalation up to 12% could mean a 12% or 44% increase to pension pot size for a 22-year-old median earner. While factors such as charge level and retiring earlier or later also have an impact, this is typically lower than increasing contributions for the duration of the member’s working life.

Charge level alone cannot be taken as an indicator of outcomes, and should be considered together with levels of return to provide an insight into value for money

Higher charges can be justified by higher returns, resulting in better outcomes for members. However, some studies have shown that neither higher nor lower charges automatically lead to better outcomes. They suggest that although some funds with active asset allocations perform better than passive funds, as a sector overall, higher charges are not necessarily a predictor of higher performance. At the same time passive funds with lower changes will never outperform the market’s benchmark returns (returns before charges are taken into account) whereas some funds with active asset allocations will.

Volatility management has the potential to decrease the chances of having negative outcomes and limit downside risk

Volatility management allows greater certainty of outcomes. It decreases the chances of having negative outcomes. Therefore, it may contribute to the outcomes of pension pot security, and trust in the pension scheme, provided that it operates in a transparent way.

Volatility management may be valuable to trustees, pension providers and members who wish to minimise detriment and to limit the range of outcomes that members might expect. This may be an approach that works for a risk-averse membership.

PPI modelling of traditional lifestyling and volatility-managed funds projects that the range of values of the volatility-managed fund is smaller. In terms of pension pot size at State Pension Age (SPA), the 10th percentile pot value is 48% of the median value (shown at 100%) for the lifestyle fund and 53% of the median value for the volatility-managed fund. The 90th percentile pot value is 207% of the median value for the lifestyle fund and 202% of the median value for the volatility-managed fund.

This suggests that individuals invested in the volatility-managed funds could have greater certainty around the range of pension pot values that they may have.

To date the pension regime has focused on value for money during the accumulation phase

In the future, Independent Governance Committees (IGCs) may want to consider value for money in decumulation. However, this role may only be extended where it is deemed that individuals are making decumulation decisions or being steered towards products that are not suited to their needs.

In decumulation:

- Members are aware that they need to make active decisions about decumulation but may not be or may not feel equipped to make these
- Communication and governance are becoming increasingly important during the decumulation phase but challenges remain around who will be responsible for this and how best to present options to members
- As with the accumulation phase, members may be best served where pension providers assess the likely behaviour of their own membership to adopt a suitable approach

In particular, the behaviour of members might have an influence on the type and volume of communication, depending on how much information members might be expected to absorb.

Similarly, member behaviour might have an impact on investment governance, with the rate at which members access their pension funds influencing the investment approach.

In conclusion, it may not be possible for IGCs and trustees to attain the best outcomes for all members. These bodies may be required to make decisions that are broadly in members' best interests. It is important to consider all determinants of value for money rather than narrowly focusing on charges.