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What can other countries teach the UK about measuring Value for Money in pension schemes?

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- Contribute fact-based analysis and commentary to the policy-making process
- Extend and encourage research and debate on policy on pensions and retirement provision
- Be a helpful sounding board for providers, policy makers and opinion formers
- Inform the public debate on policy on pensions and retirement provision.

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- Led by experts focused on pensions and retirement provision
- Considering the whole pension framework: State, private, and the interaction between them
- Pursuing both academically rigorous analysis and practical policy commentary
- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

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The future is ever changing,
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"Voice of Reason"
in the ongoing debate on the
future of retirement in the UK.

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Prior to working in research and policy Daniela was a social worker with vulnerable adults and children. Daniela has an MSc in Social Policy and Planning from the London School of Economics.

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Tim is the Head of Modelling of the PPI responsible for delivering the models and modelling to support the PPI's current research program. He joined the PPI in July 2015 and since then has analysed the projected implication of pension policies upon many significant groups. These have included the self-employed, women, younger generations, and the Exchequer.

Tim has worked alongside academics and other researchers on collaborative projects including WHeRL and CASPeR. These projects bring multidisciplinary research to widen the research scope to give a more complete view of the implications of interacting areas of policy.

Prior to joining the PPI Tim worked for Legal and General where he spent nearly ten years contributing to a wide variety of actuarial modelling projects, from financial reporting to annuity pricing.

Tim has an MA (Cantab.) having studied mathematics at Fitzwilliam College Cambridge.

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What can other countries teach the UK about measuring Value for Money in pension schemes?

Executive Summary

This summary draws out the key findings from the research and serves as the report's conclusions.

This report provides an international perspective to the current UK debate around the definition of Value for Money (VFM) in pensions. We have reviewed current UK practice and set this in context of recent developments in five other relevant countries:

- **New Zealand**
- **The Netherlands**
- **Australia**
- **Sweden**
- **The US**

There are a number of key messages from other countries that are relevant to UK Defined Contribution (DC) practice and policy:

- **A clear statement of and a consensus around the outcomes sought in assessing VFM are a necessary precondition to effecting positive change in which outcomes are expressed from members' viewpoints as things that they value.**
- **By setting clear, measurable and comparative standards and benchmarks for performance in the key areas of delivery – investment, administration, engagement – it is possible to drive a more effective tendering process for these services to secure VFM.**
- **Publicly available, consistent, robust and complete comparative data is a vital starting point for authoritative VFM assessments and broader market context. The evidence suggests that this requires a trusted regulatory framework to facilitate.**
- **There are barriers to members exercising informed choice and so where choice is provided it is unlikely to lead to good outcomes unless the choices available are carefully designed and edited. Close, active governance will be required to manage this process if good outcomes are to be achieved and maintained.**
- **Achieving scale has positive impacts on costs, but diminishing returns will set in. Large funds face new opportunities to achieve diversity in assets through unlisted or direct investments to secure consistent high returns. Evidence suggests that this will increase unit investment costs if these additional returns are to be accessed.**
- **Consistently positive real investment returns, within appropriate volatility parameters – both upper and lower – are the most significant driver of VFM in terms of net returns. But outcomes for savers in terms of meeting target income levels are most influenced ultimately by the level of contributions.**

Consensus and clarity about outcomes sought in assessing VFM are necessary

The Swedish PPM (Premiumpensionsmyndigheten – or Premium Pension Authority) experience demonstrates that clarity in, and agreement of, outcomes is necessary if operational improvements are to be delivered. Despite the detailed work of the Swedish parliamentary review, reforms to enable better choices in the funds marketplace remain to be delivered, because consensus has not yet been reached. New Zealand has gained a greater consensus post their review of member behaviour in use of default strategies which led to agreement between Government, regulator and schemes to start targeting investment strategies better for the aim of long-term investment. And the regulator's new guidance is providing greater clarity by setting out the primacy of member VFM and how providers' governance must be constructed and evidenced to deliver this. The Australian example also shows a clarity of purpose in policy through the performance testing and sanctions interventions for Super funds. What is less clear is whether sufficient consensus can be achieved between the Australian Government and industry to guard against unintended consequences.

Clear standards and benchmarks for performance drive a more effective tendering process to secure VFM.

The re-tendering process for default Kiwisaver providers shows how setting clear outcomes, for example, for consumer engagement, can ensure that these are delivered as part of an overall VFM assessment. By building engagement metrics into the specification of performance standards, the New Zealand Ministry of Business, Innovation and Employment (MBIE) can now drive the engagement action through the chosen default providers to facilitate better member choice as an integral part of the VFM outcome.

Comparative scheme data is important for assessment of VFM measures

All of the country studies show, in their different ways, the importance of comparative data as the basis both for policy formulation, governance and member engagement when designing and implementing VFM measures:

- In New Zealand, comparative scheme data on returns, charges and service is used to drive the Commission for Financial Capability's Kiwisaver fund finder selection tool for members
- In Australia, benchmarked performance testing is underpinned by reliable data, which gives the Regulator the authority to sanction underperforming products and enables members to select better MySuper solutions
- In the Netherlands, the Dutch National Bank's extensive database of scheme data has enabled detailed analysis of costs that reveals the impact of scale changes and consolidation on investment and administration costs
- In Sweden, comparative data is used to show the impact of engagement activity and the outcomes resultant in the Swedish PPM system, and
- In the US, data issues both hamper policy research around issues such as target date funds and result in market-based alternatives being created that are not then publicly available.

A cornerstone for VFM assessment and action is publicly available, consistent and robust comparative data.

Where member choice is relied on it is unlikely to lead to consistently good VFM outcomes, unless they are carefully architected and edited

The US experience of funds leakage and the Swedish example of continued investment in potentially fraudulent funds show that reliance on member choice to deliver VFM is unlikely to lead to consistently good outcomes. The PPM funds market investment proposals recognise the importance of both limiting choice to quality tested options and structuring choice to guide members to appropriate choices for their needs. This approach is also exhibited in the New Zealand fund finder tool, which guides members to select interactively from an appropriately edited set of options. The new Australian requirement for 'failing' funds to write to their members and direct them to a tool to select a better performing fund provides another example of policy interventions designed to enable more effective member choice.

Driving consolidation in the system can have positive impacts on VFM, but diminishing returns set in around £0.5bn

The experience in the Netherlands suggests that while a small positive impact on VFM can be seen from the lower cost and higher returns of larger funds, the effect is low order. Once a scale of £0.5bn is reached, the impact of scale on reduced charges is negligible. This conclusion is supported by the US experience, where biggest VFM gains are available to smallest schemes and that significant reductions in charges level off around $500m. A reliance on scale effects to make substantial improvement in outcomes, at least for those on low to median incomes, may be misplaced as the impact on VFM is marginal.

Variations in investment have a more significant impact on VFM than charges, but contribution levels and governance are vital to good outcomes

VFM frameworks that look wider than just charges will yield a more significant impact, and interventions that improve member access to additional contributions and better governance, especially of the investment process and return-seeking behaviour, are likely to be an important driver for improved outcomes.

Modelling in the report *This report explores the impact of different countries' VFM measurements on the DC pension pots of three individuals with different savings and working history. The individuals are explained in more detail in Chapter Two. This modelling is used to explore the potential difference in impact of VFM measurements if used in the UK. The summary analysis in Figure Ex.1 compares the different measurements explored in the report, alongside indicators of poor performance, to see which have the greatest positive or negative impact on the pension pot at State Pension age (SPa) of Max (a median earning male, aged 32 in 2022, who works full time from age 18 to SPa, contributing 8% of total earnings from age 22)*

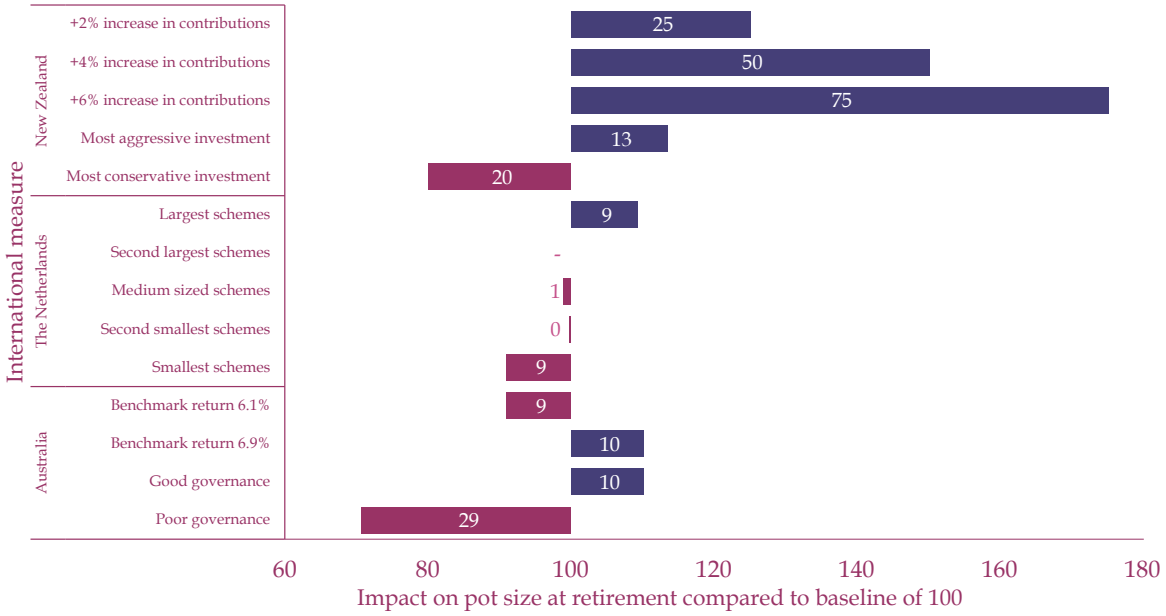
The following emerged from the modelling results (Figure Ex.1).

- The most significant impact on Max's pension pot size arose from an increase in contribution levels, with a 6% lifetime contribution increase resulting in a pension pot of 75% higher at SPa.
- Measures which focus on investment returns, such as in Australia and New Zealand, had a greater impact on Max's pension pot size at SPa, increasing it by between 10% and 13%, compared to measures focussing on charges, such as the Netherlands and Sweden, which increased Max's pot size by up to 9%.
- Good governance, as measured in the Australian example, also had a significant impact, increasing Max's pension pot by 10% at SPa.

Figure Ex.1[1]

Increased contributions have the largest impact on Max's pot, while a focus on investment returns and governance also significantly increase the pot size

The impact of VFM measures and indicators of poor performance on the pension pot at SPa of Max, a median earning male, aged 32 in 2022, who works full time from age 18 to SPa, contributing 8% of total earnings from age 22, compared to a baseline of membership in a large UK master trust scheme



Outcomes from DC pension saving are most affected by investment uncertainty and volatility

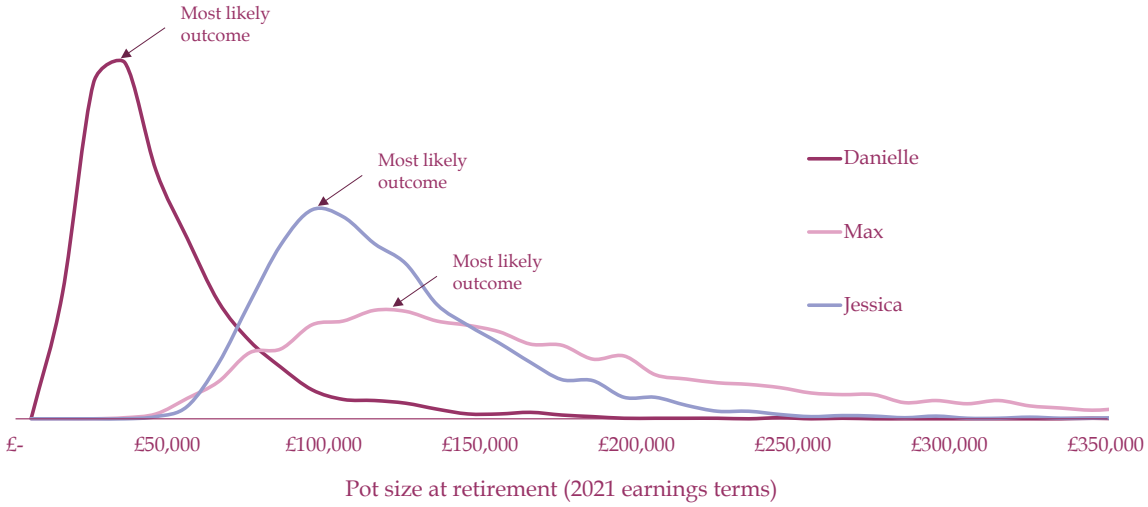
While VFM measures and behaviour can help improve long-term savings outcomes, net returns from saving into DC schemes rely on investment conditions and inflation rates which can fluctuate and are not entirely predictable. If a range of possible investment return and inflation scenarios are taken into account, then the eventual pension pot sizes of the three individuals vary considerably (Figure Ex.2) and the differential impact is greater than any of the VFM measures modelled. Therefore, concerns about the potential impact of poor scheme behaviour on member funds should also include consideration of how members' retirement expectations can be protected against potential fluctuations in fund amount arising from changing economic effects.

1 PPI Modelling

Figure Ex.2[2]

Outcomes from DC pension saving are most affected by investment uncertainty and volatility

The distribution of outcomes for pot size at SPa for each individual. This is generated using stochastic projection of future economic conditions based upon OBR's long-term economic determinants.



What could a VFM framework look like?

Using the international research findings from the report, it could be concluded that a VFM framework should include the following elements (figure Ex.3):

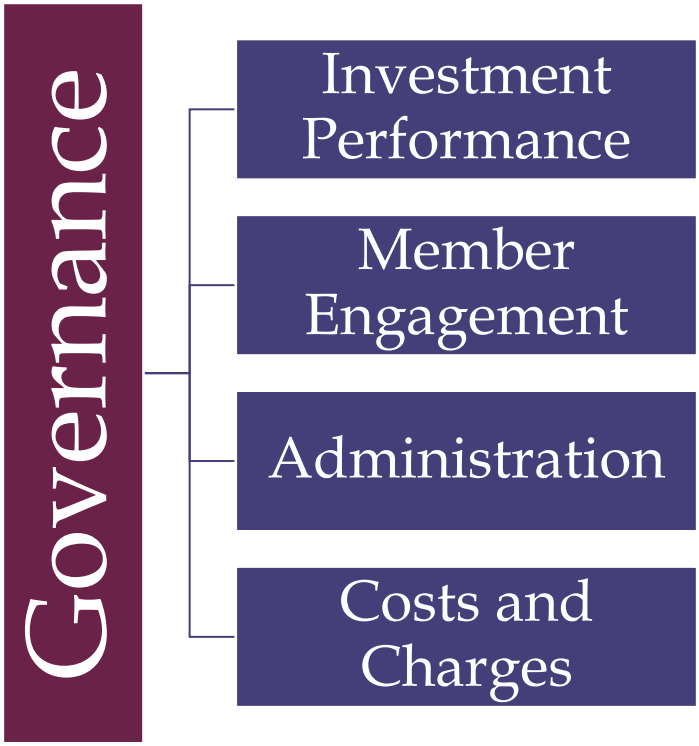
- Investment performance
- Member engagement
- Administration
- Costs and charges

Overarching these elements is the need for good governance of the system. It is governance that has the power to set, monitor and amend the delivery of the various services to schemes and their members so as to maximise the VFM and consequently the outcomes, in terms of retirement incomes.

2 PPI Modelling

Figure Ex.3

A possible international VFM framework



In translating this to the UK environment, there is a need to consider a number of factors, including:

- The lack of compulsion on members to join and remain in schemes – this places weight on the need for individuals' implicit trust in their employer and scheme to support automatic enrolment
- The choice of scheme and suppliers lying with the employer – meaning that UK DC is a technical industrial market, not a retail one: the member has no effective choice of product or terms
- The relatively low level of default contributions – which negatively effects the economics and commercial attractiveness of many schemes, regardless of size
- The access to large and well-developed investment markets and fund products in the UK – which provides access to a wider range of asset classes in high quality funds
- The recent but rapidly growing scale of UK DC provision – which means market economics and structures are changing rapidly in response to scale
- The lack of a legislated, standardised DC savings product in the UK – which means that each scheme tailors its offer to match its members circumstances and needs, so that comparisons must consider quality alongside price
- The lack of a mechanism to prevent fragmentation of savings into multiple pots as a result of job mobility – which makes the system less economic, but supports the continuing engagement of those employers who provide more than the minimum as part of their employment proposition

Introduction

Charging structures for Defined Contribution (DC) pension schemes continue to come under close regulatory and Governmental scrutiny since the introduction of an initial Charge Cap for accumulation. This focus is expected to continue with further interest in driving down charges as well as the potential introduction for decumulation.

The Pensions Policy Institute (PPI) is looking to continue to inform the ongoing debate around a broader definition of Value for Money (VFM) with the Government, Regulators and the wider industry, to improve members' outcomes. This improvement is recognised to not just be the result of a race to reduce costs, where it has a negative impact upon the quality of the scheme, its services and governance.

Chapter one discusses the current debate around Value for Money in UK DC pension schemes and current practice in evaluation amongst large DC schemes and insurance companies.

Chapter two examines recent changes in New Zealand's KiwiSaver retirement savings scheme, and the steps taken by the NZ Ministry of Business, Innovation and Employment (MBIE) and Financial Markets Authority (FMA) to improve VFM for those saving in the scheme.

Chapter three examines analysis of investment cost data from Dutch pension schemes, collated by the regulator, the Dutch National Bank (DNB), and looks at drivers of VFM associated with increased scheme size.

Chapter four examines a pensions market review by the Australian Productivity Commission and subsequent Superannuation system reforms, designed to protect savers from underperforming funds.

Chapter five explores how the use of choice as a key system element in Sweden has led to poorer returns for some pension members, and how a lack of clear objectives can make it difficult to push through regulatory change.

Chapter six explores the leakage of funds in the US workplace pension system, concerns around the use of Target Date Funds and the importance of publicly available data for supporting VFM.

A note on VFM Modelling

In order to explore the potential variations in outcome for scheme members in the UK, based on VFM measures from other countries, this report uses hypothetical vignette modelling (PPI Individual Modelling). This modelling uses three hypothetical individuals in order to explore how different VFM measures, or indicators of poor performance, could affect the pension pot size at State Pension age (SPa) of people with different working and saving histories, and how close they are to achieving a target level of income which could allow them to replicate working life living standards in retirement. The modelling outcomes are not intended to represent actual projections of what will happen to future savers, but rather to illustrate the potential scale of impact different experiences might result in.

The following three individuals are used to provide these illustrations throughout the report:

Danielle – Danielle is a median earning woman who works part time throughout her working life, age 18 to SPa. She is aged 22 in 2022 and earns £12,000pa. She contributes to a DC pension, with her employer, at 8% of band earnings until SPa.

Max – Max is a lower earning man, (at the 30th percentile) who works full time throughout his working life, age 18 to SPa. He is aged 32 in 2022 and earns £25,000pa. He contributes to a DC pension, with his employer, at 8% of whole earnings until SPa.

Jessica - Jessica is a median earning woman, aged 42, who is currently not in employment as she is caring for children. She returns to work full time at age 50 and works up until SPa. She is aged 42 in 2022 and would have an indicative income of £35,000pa if she was currently working.

All individuals are assumed, under the baseline:

- To be invested in a default strategy representative of an industry default fund in a large master trust scheme with a member charge of 0.5% of funds under management and an asset allocation mix of 79:2:19 Equity: cash: bonds
- Experience lifestyle de-risking of funds which begins 10 years prior to SPa

Chapter One: Where are we now with Value for Money (VFM) in the UK?

This chapter discusses the current debate around VFM in UK Defined Contribution (DC) pension schemes and current practice in evaluation amongst large DC schemes and insurance companies.

This report was informed by literature review, discussions with pensions policy experts from the relevant countries and discussions with Independent Governance Committee (IGC) Chairs and trustees. We would like to thank them for their contribution to this project. The Pensions Policy Institute (PPI) takes responsibility for all editing decisions.

Chapter summary

Discussions about VFM in DC pensions have recently been given greater attention by Government, regulators and pension scheme providers.

- The relatively recent introduction of VFM guidance for trustees, and the requirement for contract-based schemes to set up IGCs, has led to more discussion about how to assess VFM
- The VFM approach set out for trustees is more principles based, while the approach followed by IGC's is more task based
- VFM assessments can be based on comparisons or benchmarks
- Members care less about charges than other VFM measures
- Education and communication are key ways of helping members to pursue better outcomes for themselves
- The Pensions Regulator (TPR) is exploring ways of making VFM assessment easier for schemes in the future and discussions continue

Prior to 2016, there was less of a focal point for discussion about the extent to which DC schemes provided VFM to their members

Previously, VFM debates tended to revolve around charges, reinforced by the 2015 introduction of the member charge cap on default strategies used for automatic enrolment of 0.75% of funds under management.[3]

In 2016, TPR published a VFM section in their DC code (which sets out the standards that TPR expects DC providers to meet when complying with the law).[4] Around the same time, the Financial Conduct Authority (FCA) introduced the requirement for DC contract-based schemes to set up IGCs, which had the remit of assessing the extent to which schemes provided VFM to members

3 DWP (2014)

4 www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/5-value-for-members

and holding them to account in areas where VFM was lacking.[5] These steps moved the VFM debate beyond simply looking at charges, and led to discussions between industry, regulators and the Government regarding how best to measure and present VFM.

It was felt at the time that it may not be possible for IGCs and trustees to attain the best member outcomes for all members, due to affordability issues and the need for defaults which aim to provide the best VFM for the typical member, and so these bodies may be required simply to make decisions that are broadly in members' best interests.[6] Also, while there was no single definition of VFM, it was possible to identify three outcomes that are positive for members across the board:

- Value of the pension pot
- Security of the pension pot
- Trust in the pension scheme[7]

Contribution rates, investment returns, and charge levels and structures all 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.[8]

A principles-based VFM process was set out in TPR guidance for trust-based schemes

TPR's DC code guidance set out legal requirements on trust-based schemes for annual assessments of VFM, which focus on value provided in return for member charges and the influence these could have on future member outcomes. The guidance provided an illustrative four-step process to follow in assessing value, namely to:

1. Gather information on **what the scheme provides for members and at what cost** in the core areas of scheme governance and management, investment, administration and commutations
2. Assess the **scope and quality of scheme services** to members, with particular reference to member need and performance
3. **Evaluate the scope and quality against costs,** considering whether they represent good value for those costs and charges incurred by members, and whether these justify any difference in cost when compared to similar schemes and options available
4. **Report on the outcomes and take action to address poor value,** setting out the levels of charges and costs, and explain the value for members assessment in the Chair's statement[9].

Current practice as set out in trustee Chair's statements follows this broad approach

Large, trust-based, DC schemes show a consistency of overall approach that follows much of the guidance.[10] The following similarities appeared in the reports analysed:

- The emphasis is on describing the process and confirming its completion and overall conclusions.
- There is less detail on the methodology used in assessment, and the data collected and analysed. The assessments are presented as a binary conclusion rather than a graded performance.
- There is no apparent discussion or critical examination of the tensions or trade-offs being managed in the delivery of services, such as around cost/performance, risk/reward or engagement effort and outcome.

5 www.fca.org.uk/firms/independent-governance-committees

6 PPI (2016)

7 PPI (2016)

8 PPI (2016)

9 TPR (2019)

10 Based on PPI analysis of three large master trust Chair's reports and a multi-employer scheme annual report

- The emphasis of discussion is around service conformity and charges; commentary on investment tends to focus more on strategy and governance than resulting performance or outcomes.
- External comparisons are not widely used and are limited to those within the trust sector, but there are some references to consultancy reports used to provide external perspectives.
- Reports do highlight a wider range of services provided by some schemes, especially around accessing funds at retirement.

Contract-based VFM assessments are more task based than principle based

FCA rules[11] require IGCs to assess VFM by exploring:

1. Whether default investments are designed and executed in the interests of members
2. Whether investment strategies characteristic and performance are regularly reviewed and action taken to make necessary changes to align with members' interests
3. Whether core scheme financial transactions are processed promptly and accurately
4. The levels of charges borne by members
5. Direct and indirect costs incurred in managing and investing pensions savings of members
6. Whether communications to members are fit for purpose, taking into account members' characteristics, needs and objectives.

The IGC chair is then required to ensure the production of an annual report setting out the opinion on the VFM delivered. These rules provide a rather different framework for IGCs. The assessments read more as a list of tasks than an integrated series of principles, and also suggest a more granular approach to the assessment process.

IGC VFM assessments reflect a different approach in response to FCA rules

IGCs approach VFM assessment in a different way than trustees.[12] Each starts with a wider framework in which to place the assessments required under the rules, articulates the elements of value that it sets out to assess and then presents details of the key indicators of performance measures against these elements. While not identical, there is a good deal of alignment in these frameworks between IGCs.

Each has then constructed a graded assessment for each element of value as a number or colour score, together with a descriptive statement. Reference is made to external research and benchmarking research conducted by third parties. They also comment on progress observed and areas for improvement. Finally, they give an overall assessment, sometimes as a weighted score, with a statement indicating to what extent VFM has been delivered - albeit as a qualitative rather than quantitative assessment.

In the reports there is also a sense of where there is differing availability and precision of management information on which to make judgements. This is particularly seen in connection with older books of business that contain contracts no longer actively marketed.

The difference in detail and tone is perhaps unsurprising given the different roles that IGCs and trustees fulfil in the governance of their schemes. Trustees report as the ultimate governance body of the scheme to their beneficiaries, the scheme members. The levers of governance are ultimately theirs to pull. IGCs effectively lobby firms' management, albeit with regulatory powers to back them, on behalf of the members. Their reports are therefore more audits of performance of the management in the discharge of their duties to customers. It is the management (and ultimately their Boards) that hold the levers of governance. These differences could result in different VFM outcomes for members in different scheme types.

11 COBS 19.5

12 Based on PPI analysis of three IGC reports

Assessments can be based on comparisons or benchmarking

Within IGCs there is an emphasis on "comparative analysis", generally comparing selected outcomes with those found in other schemes, rather than service or net-return specific benchmarking to an absolute level. This is partly because within UK pensions, there is no standard product for automatically enrolled (or other) schemes.[13] This contrasts with the systems in Australia and New Zealand, for example, where the MySuper and Kiwisaver products have many features prescribed by regulation. In these markets, a benchmark approach is more appropriate for comparison as common standards are being applied.

In the UK, the market still offers employers a range of scheme designs with different cost and quality trade-offs. This is particularly apparent between those schemes designed to capture business from employers setting up new schemes in response to their automatic enrolment duties and those designed for employers with pre-existing pension arrangements. It is therefore seen as more challenging to draw appropriate comparisons, not least because the market does not offer a ready mechanism to assess and measure these trade-offs. It is the job of governance to define where the scheme seeks to strike this trade-off. It must then determine that this is suitable, in general, for the members, whether it is delivering this in the most efficient way, and what action must be taken to ensure it does.[14]

Members assess value more widely than charges

The VFM attribute which members rate most highly is a good return on contributions, measured by total money going in vs. the quality of pension provision and member experience. Members are also highly concerned about the financial security of their pension.

Charges are not front of mind for members. This is in part attributed to low understanding, but is also influenced by views that the quality of the overall pensions experience is more important. As long as pricing is fair and in line with the competition, then members believe other elements of their pension experience are more important. But many members fail to understand the impact of charges on their good returns.[15]

Education and engagement are important to members in delivering good outcomes and VFM

Education helps members to better understand how to pursue good pension saving outcomes, and members place more value on support and engagement tools when they understand pensions better.[16] It is possible to have a meaningful discussion with members about what represents VFM in workplace pensions; but to achieve this, it is necessary to deliver some basic education to compensate for wide levels of poor pension understanding. Overall, informed members want providers to do two things for them:

- Act on their behalf to manage investments to deliver good pension outcomes, and
- Nudge them to do those things that will help them to achieve good pension outcomes.

In this second area, the two most desired benefits were making information available to show the impact of contributions and proactively prompting consumers to take action themselves. Members put a value on these things that is greater than the cost of their provision.[17]

13 Discussions with IGC and Trust Chairs

14 It can be argued that there is a clear benchmark scheme in the UK system which is NEST. This is, by statue, available to all employers to use, underpinning the automatic enrolment system. Whilst it is clear that NEST is an obvious comparator, this universality makes its position and supporting economics and financing unique. No other competitor can emulate NEST. So, whilst it may be right to compare offering to those of NEST, if appropriate, it can also be argued that NEST cannot be presented as a benchmark as its position is unique and not replicable.

15 Craig, J (2017); Edmans, LM (2017), both of these primary research studies were conducted on behalf of IGCs

16 Craig, J (2017), *The employee view of 'Value for Money' in the workplace,* NMG

17 Edmans, LM (2017), *Chair's report 2016/17,* Zurich Independent Governance Committee citing external primary research

Regulators are consulting on how to move forward VFM measurement and assessment

As part of a joint regulatory strategy, both TPR and FCA identified in 2018 a new priority for joint action to set and enforce clear standards for delivering VFM, developing further common principles and standards, and holding schemes and providers to account for delivery of those standards.[18]

In June 2020, FCA issued new proposals to promote a consistent approach to assessing VFM in contract-based schemes, ensuring IGCs take into account three key elements of value:[19]

1. Charges and costs
2. Investment performance
3. Service provided (including member communications)

Assessments would include comparisons with other reasonable market options or, if available in the future, relevant benchmarks[20]. These proposals built on the requirement for scheme governance bodies to publish costs and charges introduced under PS20/02.

TPR and FCA have issued a 2021 joint discussion paper setting out a holistic framework and related metrics for all DC pensions schemes. This is also built around three core VFM elements: investment performance; scheme oversight (including customer service); and costs and charges - with suitable VFM metrics and benchmarking driving IGC and trustee assessment of comparative performance to drive better risk-adjusted investment performance, improved engagement and lower charges.[21]

This is supported by the introduction of new requirements from October 2021 by the DWP for trustees of schemes under £100m of assets to carry out and report on holistic assessments of how their scheme delivers value for money, and for all schemes to report on their investment returns on the Chair's statement[22].

The discussion process continues and consultation responses are invited by 10 December 2021. This paper is designed to contribute to this process by bringing evidence and learnings from other relevant pension systems.

18 FCA & TPR (2018)
19 FCA (2020)
20 FCA (2020)
21 TPR & FCA (2021)
22 DWP (2021a)

Discussions about VFM in DC pensions have recently been given greater attention by Government, regulators and pension scheme providers.

- Previously, VFM debates tended to revolve around charges
- In 2016, TPR published a VFM section in their DC code, setting out VFM standards that TPR expects DC providers to meet and the FCA introduced the requirement for DC contract-based schemes to set up IGCs with the remit of assessing the extent to which schemes provided VFM.
- IGCs and trustees fulfil different roles in the governance of their schemes. Trustees report as the ultimate governance body of the scheme to members while IGCs effectively lobby firms' management, with regulatory powers to back them, on behalf of members. IGC reports are more audits of performance of the management. These differences could result in different VFM outcomes for members in different scheme types.
- Within IGCs there is an emphasis on "comparative analysis", generally comparing selected outcomes with those found in other schemes, rather than service or net-return specific benchmarking to an absolute level.
- The VFM attribute which members rate most highly is a good return on contributions, measured by total money going in vs. the quality of pension provision and member experience. Structured prompts and information at the point of choice helps members to better understand how to pursue good pension saving outcomes, and members place more value on support and engagement tools when they understand pensions better.
- As part of a joint regulatory strategy, both TPR and FCA identified in 2018 a new priority for joint action to set and enforce clear standards for delivering VFM, developing further common principles and standards and holding schemes and providers to account for delivery of those standards.
- TPR and FCA have issued a 2021 joint discussion paper setting out a holistic framework and related metrics for all DC pensions schemes. This is also built around three core VFM elements: investment performance; scheme oversight (which includes customer service); and costs and charges.

Chapter Two: New Zealand – clarifying purpose and expectations for KiwiSaver

This chapter examines recent changes in New Zealand's KiwiSaver retirement savings scheme and the steps taken by the New Zealand Ministry of Business, Innovation and Employment (MBIE) and Financial Markets Authority (FMA) to improve Value for Money (VFM) for those saving in the scheme.

Clarity of Purpose, clear expectations and co-operative working provide the foundation to drive for better VFM

- The recent retendering for default fund providers conducted by the NZ MBIE establishes minimum performance standards which enable clearer assessment of VFM.
- A reassessment of the usage of default funds by members has resulted in a significant change in mandated investment strategy, which promises enhanced returns for default members.
- New FMA guidance on fund manager fees and VFM has been issued, setting clear expectations of the need to demonstrate reward for investors in return for the level of fees charged and of the FMA's intentions to take action against firms that it determines are acting unreasonably.
- There is a clear sense of co-operative working between Government, the regulator and the consumer finance education body to provide a choice architecture to support members in engaging with their savings and making better choices.
- A significant minority are contributing more than the default amount. This may be evidence of a greater engagement with retirement savings needs.

The KiwiSaver review demonstrates the importance of setting minimum standards and appropriate default investment strategies

KiwiSaver has clear parallels with UK automatic enrolment

KiwiSaver is New Zealand's work-based retirement saving scheme. It is similar in purpose to the UK's automatic enrolment programme, based on automatic enrolment in the workplace at similar contribution levels with contingent compulsion on employers to contribute unless the employee opts out or stops contributing. A key difference is that it is the employee who chooses which provider will invest their savings, or, failing this, a provider is put in place through a carousel process from a list of appointed default providers.

Recent retendering of default providers has provided opportunity to improve VFM for members

The NZ MBIE has just completed a septennial review of default providers for KiwiSaver. The Ministry was under some pressure to improve the value provided by default providers which were criticised as providing low returns[23] and charging high fees.[24]

23 Ruth, J (2019)

24 Birdsey, N (2020)

Changes have been made to default fund strategy to match actual member behaviour

It had been previously assumed that the potential to earn higher returns in a more growth-oriented fund would encourage members to actively choose the best fund for them. In reviewing the default arrangements, the MBIE concluded that many default members were not engaging with their accounts in the way that had been expected and were remaining in their default funds without making an active choice to do so. MBIE decided, following consultation with the FMA, to move away from encouraging a conservative investment strategy for these funds with 15%-25% invested in growth assets, to a balanced investment strategy with between 35% and 65% invested in growth assets.[25]

The impact of default strategy choices

In order to illustrate the potential impact of a similar strategy in the UK, this report models the difference in the potential size of pension pot at State Pension age (SPa) for the three individuals if their pots are invested in the most aggressive and most conservative UK default investment strategy. No other assumptions, for example on charges, are changed. This aims to translate the MBIE's decision to change default strategy for KiwisSaver into a UK context. The scenario calculates the target amount these individuals would need to receive in order to replicate working life living standards in retirement, using the metric of replacement rates as formulated by the UK Pension Commission[26]

Under these assumptions, Danielle and Max could receive a pension pot around 40% higher (32% closer to Max's target) under the most aggressive asset allocation, and Jessica's pot could be around 20% higher (4% closer to her target) (Figure 2.1).

However, a higher degree of variability in outcome would also be expected given the higher, more volatile, equity content although lifestyling may help to limit the impact of this near the point of pot access.

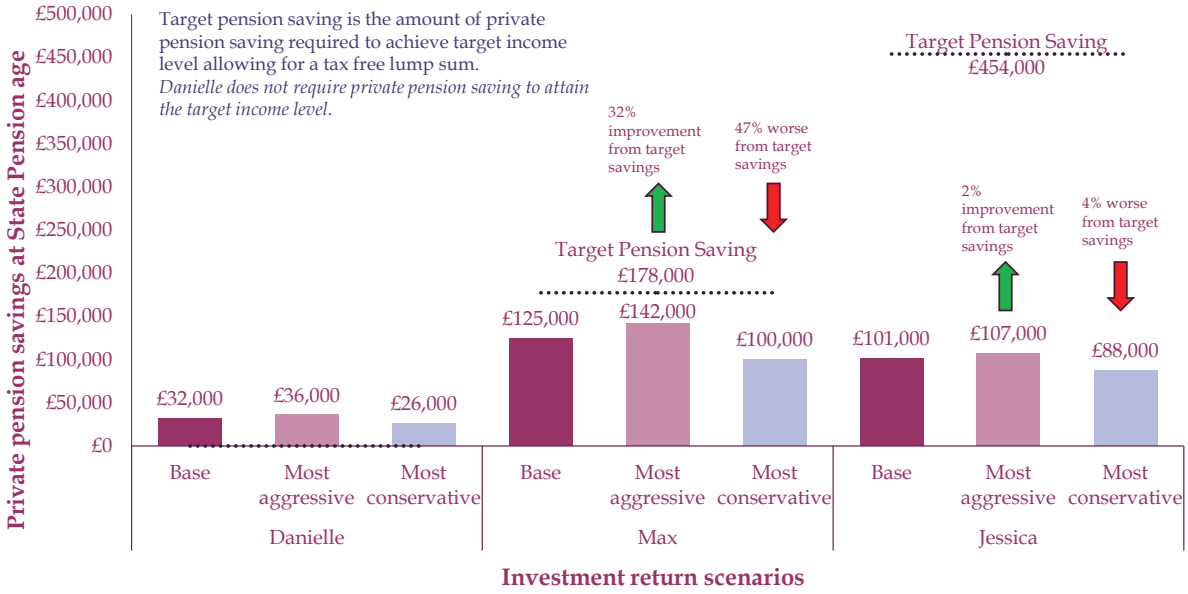
25 Accessed from fundfinder.sorted.org.nz (1 September 2021) The average conservative fund has 30% invested in shares and 70% in bonds whilst the average balanced fund has 60% invested in shares and 40% in bonds. Average returns over the 5 years to March 2021 are 4.1% and 6.2% respectively

26 See Modelling Appendix for details

Figure 2.1[27]

Moving from the most conservative UK asset allocation to the most aggressive yields a pension pot of 20% to 40% higher for some individuals

Private pension savings at SPa before tax free lump sum, for each individual under the least and most aggressive Defined Contribution (DC) UK pension asset allocations, measured against target income replacement rates (2021 earnings)



Engagement standards set as gateway to default provider status

The process of retendering to be a KiwiSaver default provider was also amended to require providers to submit fee proposals separately from other proposals. VFM was considered in a two-step process: first establishing that the provider can meet the required minimum overall criteria and then assessing member fees against performance on qualitative criteria. The criteria included standards for the delivery of the investment product, member experience, management of transitions and governance/financial standing. These also included minimum standards for customer engagement, with information and advice at key points in their customer journey which could materially influence their outcomes - holding providers accountable for their delivery. Details of these criteria are set out in Appendix 2.

Using this process, MBIE believed they were able to put downward pressure on fees by sending the clearest signal to prospective providers of the importance of low fees, while safeguarding against a 'race to the bottom' by setting clear minimum standards that every successful provider will have to provide regardless of their fee proposal. This resulted in a much clearer process and rationale for officials to compare, negotiate and select providers - and resulted in significant reduction in fees, while also establishing consistent standards required to be maintained if default provider status was to be retained.[28]

Reduced fees and more innovative providers secured for default members

MBIE will reduce the number of default providers from nine to six from 1 December 2021, with the new set of providers charging lower member fees than previous, and no fixed fees, which will especially benefit those with low account balances[29] (Figure 2.2).

27 PPI Modelling

28 MBIE (2020a)

29 NZG (2021)

Figure 2.2: New and current KiwiSaver default funds providers and charges[30]

Current Providers	Current Fee %	+ Current Member monthly fee NZ$	New Providers	New Fee %
Bank of New Zealand	0.50	-	Bank of New Zealand	0.35
Booster	0.38	-	Booster	0.35
BT Funds Management (Westpac)	0.47	$1.83	BT Funds Management (Westpac)	0.40
Kiwi Wealth	0.52	-	Kiwi Wealth	0.37
Mercer	0.47	$2.25	Simplicity	0.30
Fisher Funds	0.52	$1.95	Smartshares (NZX)	0.20
AMP	0.39	$1.95		
ASB	0.40	$2.50		
ANZ	0.44	$1.50		

MBIE estimate that a member joining the scheme at 18 on a salary of NZ$50,000 (£25,000) will have an increase of NZ$143,000 (£71,500) in their savings balance at age 65, an extra NZ$56,000 (£28,000) in today's terms, as a result of the change in the default investment strategy, and will also save around NZ$3,900 (£1,950) in fees or NZ$2,400 (£1,200) in today's terms.[31,32]

Policy and regulatory action work better in tandem

In New Zealand, there is a regulatory overlay of VFM principles

A complementary intervention by the FMA has been added to the changes driven by setting out four VFM principles that the regulator requires to be applied by fund providers. These apply to all funds, not just the KiwiSaver default ones. The principles are set out as follows:

1. **Risk and return are critical** - the two key indicators of VFM for members are how well the manager's process and capabilities appropriately minimise the investment risk the member experiences (i.e., through volatility and loss); and the member's return after fees.
2. **The financial value of investment management must be shared** – a member has not obtained the financial value of investment management if it is not shared appropriately between the manager doing the work and the member paying the cost, providing the capital, and therefore taking the risk.
3. **Advice and service is received, not just offered** - a service or feature provided by a manager contributes to a member's VFM if it demonstrably helps the member make better investment decisions (such as advice), or demonstrably benefits the member's account (such as investment process reducing market risk, enhancing return or both).
4. **Review yourself as you review others** - when evaluating their fees and VFM to members, managers should use the same rigour they would apply to assessing the same of any underlying manager.

The FMA commented that, ultimately, it will be the market which punishes unreasonable fees and poor value. But the FMA can and should try to influence the industry's approach to make it happen sooner. Guidance which introduces a stronger discipline of examination of fees and VFM is how to make that happen.

Principles separate inputs and expected outcomes

These principles act as guidance to fund managers and supervisors of schemes when demonstrating performance of their statutory duties, including their required annual reviews of

30 NZG (2021)

31 NZG (2021)

32 Conversion to Sterling at NZ$2 to £1

fees and VFM. The principles set out with a good deal of clarity what is most important in the FMA's view. They usefully separate inputs and expected outcomes rather than conflating these. So, guidance focuses on evaluation of the scheme's actions, for example investment process and capability and appropriate sharing of value, and then sets measures to assess these with, for example, volatility/loss and returns and work and cost.

The guidance goes into further detail as to how FMA expects managers and supervisors to apply the principles and the questions that they should ask, answer and evidence in their assessments.[33]

It also links to the standards set out in the MBIE tendering process, underlining that the value of advice and service is in positive actions that result in better member account outcomes. This suggests that while there has been an acceptance that default funds need to be regarded as long-term strategies due to observed member inertia, both Government and regulator are working to drive more engagement of savers through the actions of providers and holding providers accountable for this.

Engaging consumers requires further reinforcing actions

Consumer education body supports choice architecture

The continued drive for engagement is reinforced by the consumer education body, the office of the Retirement Commissioner, who provide a suite of tools and calculators for consumers to assist with managing their finances through their Sorted website.

For KiwiSaver, the Sorted website provides a fund finder tool[34] with an architecture that leads the member through the considerations and choices around fund type and individual fund section using real data for fees, services and returns, with anchoring averages, in a clear and informative process. The savings calculator[35] then enables expected outcomes to be modelled in terms of fund at retirement and weekly incomes. Studying the way that these support the policy to drive active choice and requirements on providers to act may be helpful in thinking about how the pensions dashboard might be developed as an engagement tool in the UK

A significant minority are contributing more

Whilst the majority (62%) of participants report contributing the minimum 3% or 4% to KiwiSaver, a third reported contributing 6%, 8% or 10%.[36] This suggests some wider engagement has been generated amongst those who have been auto enrolled with the need to save, and that this engagement has been translated into action.[37]

Contribution rates are significant to outcomes

In order to illustrate the potential impact in the UK of members contributing more, potentially as a result of scheme communications and engagement strategies, this report models the impact on the vignette individuals' pension pot sizes at SPa of increasing their contributions by 2%, 4% and 6%, whilst keeping other assumptions the same.

For Danielle, each additional 2% contribution yields a further £8,000 to £9,000 in pot size, increasing it by just under 100% for an additional 6% contribution. For Max, 4% and 6% additional contributions mean he exceeds the amount required to achieve his target replacement rate retirement saving, which is not likely under lower contribution scenarios. For Jessica the effect is much less marked due to the much shorter remaining savings period to access. But even here there is just short of 40% rise in pot size for 6% extra contributions (Figure 2.3).

33 Financial Markets Authority (2021), *Managed fund fees and value for money,* FMA

34 Accessed at www.fundfinder.sorted.org.nz

35 Accessed at www.sorted.org.nz/tools/kiwisaver-calculator

36 FSC (2021)

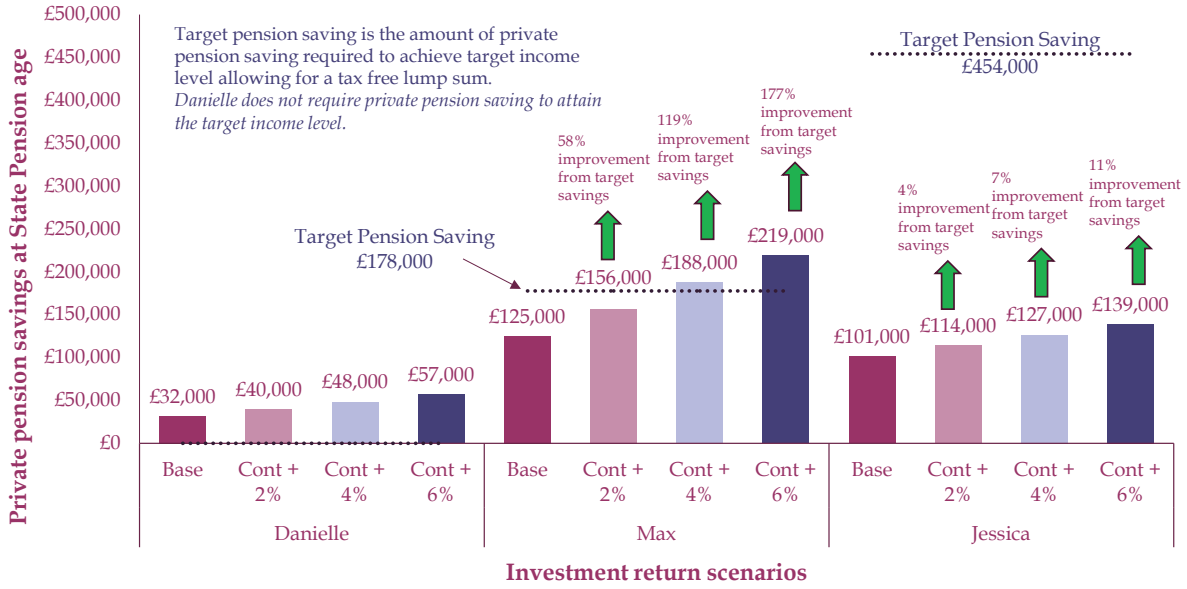
37 It should be noted that this saving may also be motivated by saving for a house. Kiwisaver provides a withdrawal mechanism for buying a first home.

Max would be 58% closer to his pensions target with a 2% increase in contributions. Jessica, with less time remaining to save, would close the gap to her target by 4%, 7% and 11% with increased contributions of 2%, 4% and 6% respectively. Any additional contributions would result in Danielle over saving by this measure and also achieving a level of income above the Minimum Income Standard. This may not be the optimal use of scarce resources for her if it is likely to result in significantly increased hardship during her working life.

Figure 2.3[38]

Increasing contributions will make it easier to meet target retirement incomes

Private pension savings at SPa before tax free lump sum, by each individual with increasing contribution rates, measured against target income replacement rates (2021 earnings)



Lessons for the UK

New Zealand's experience with KiwiSaver shows the importance of clarity of objectives with VFM

- The recent re-tendering process for KiwiSaver shows how improvements in VFM may be achieved by better understanding the drivers of retirement pot outcomes and the levers available to policymakers to bring about positive change. Their analysis is that market forces may not act quickly enough for current savers, both because of the long-term nature of saving and the difficulties in achieving engagement from savers.
- Their solutions suggest that policy makers need to be ahead of the change curve to drive better outcomes – here in investment strategy, fees and engagement – and that a suite of interventions, linked by common policy, may increase the effectiveness of individual actions by reinforcing their effects.
- Changes to default strategy promise significant differences to outcomes although the UK scope is less than in New Zealand's KiwiSaver.
- The value of advice and other service can be measured through positive actions that results in better member account outcomes
- Both the Government and regulator can work to drive more engagement of savers through the actions of providers by holding providers accountable for this.
- Evidence of the impact of engagement may be seen in the significant minority of savers contributing more than the default minimum – this has the potential to make substantial improvements to outcomes.

38 PPI Modelling

Chapter Three: The Netherlands – the interaction of Value for Money (VFM) and economies of scale

This chapter examines analysis of investment cost data from Dutch pension schemes, collated by the regulator, the Dutch National Bank (DNB), and looks at drivers of VFM associated with increased scheme size.

Unused cost economies of scale in the Netherlands have declined to values close to zero

- Evidence from the Netherlands is that while economies of scale in investment costs are still available for smaller schemes, for larger schemes such economies have largely been exhausted.
- Investment costs are six times the level of administration costs in the Netherlands, so administration savings present little further opportunity for Dutch schemes.
- Large pension funds are more likely to pay performance fees for complex asset categories. Such fees reduce the traditional cost economies of scale results for the entire portfolio.
- For Dutch schemes it appears that further cost savings by consolidation, while possible, are very limited. Even if all the smaller Dutch schemes were to merge, the reduction in investment cost resulting would be just 0.5% of total investment costs for all schemes, a very limited saving.
- The opportunities from increased scale lie in accessing returns from a wider range of assets, but improved investment returns are not evidenced from this Dutch dataset

Consolidation has been advanced in the UK as an important strategy to increase VFM

In June 2021, the UK DWP consulted on the case for greater consolidation in the Defined Contribution (DC) market. In his forward, the pensions minister stated that "there is no doubt in my mind that there must be further consolidation in the occupational DC pensions market" as "scale is the biggest driver in achieving VFM for savers and ultimately better retirement outcomes." Evidence was sought on barriers and opportunities for consolidation of schemes in the range £100m to £5bn and an intention to examine the opportunities for larger schemes was also signposted.[39] Feedback of evidence from the consultation is awaited, following its closure at the end of July 2021.

Scale effects in the Netherlands have been declining for years

Analysis of the economies of scale in 240 Dutch pension funds into scale effects in investment costs, the dominant component of pension fund costs, revealed a remarkable downward trend. Large economies of scale were found for the Netherlands of, on average, 22% during 1992-2004 and 20% in 1992. However, in the last decade there seems to have been an absence of any economies of scale: 0% in 2009 and 0% over 2002-2013 as the market has matured and many small schemes have consolidated.[40]

39 DWP (2021b)

40 Meaning that the investment costs increased by 78 percent if the invested capital doubles

This contrasts sharply with the continuing and significant economies of scale in administration costs of pension funds, as observed in the same studies, even though these followed a downward trend, too: from 36% in 1992-2004 and 29% in 1992-2009, to 10% in 2002-2013. However, investment costs in the Netherlands are around six times the level of administration costs.[41]

A decline in economies of scale is to be expected. Three quarters of Dutch pension funds, particularly the smaller ones, have been consolidated since 1992. But economies of scale falling to, on average, zero, as apparently seems to be the case with investments, appears counter-intuitive. The possible answer lies in changes to investment strategies in these large funds.

Larger funds tend to incur higher investment costs in search of higher returns from costlier assets

Analysis of costs at the level of asset class shows that some assets entail higher costs (and generally higher expected risk-weighted returns) and that larger pension funds invest in more complex and costly assets in search of these higher returns (Figure 3.1). No evidence of higher returns is available from this analysis.

Figure 3.1: Dutch funds' investments and cost margins by asset class (2012 and 2019) [42]

	Investments €bn		Costs (in %)	
Asset class	**2012**	**2019**	**2012**	**2019**
Fixed income	441	815	0.19	0.16
Stocks	251	438	0.28	0.23
Real estate	79	136	0.92	0.72
Hedge Funds	26	26	3.38	2.68
Commodities	2	4	2.45	2.25
Private equity	40	71	3.08	3.70
Total	*838*	*1,471*	*0.54*	*0.49*

Potential for further economies of scale exist, but are limited

Modelling by the Dutch analysts of the cost-size relationship concludes that if all smaller and medium-sized pension funds were of the scale of the fifth largest pension fund through growth, mergers or take-overs, then their investment costs in 2019 would decline by only 1.4% (€36m or £31m). This is less than 0.5% of the total investment costs for all funds in total. On the other hand, when two large pension funds merge, they have the potential to save 2.5-3% of their investment costs.[43] Therefore, some economies of scale do exist but they are only moderate and can decline as schemes grow in size.[44]

In order to illustrate the potential impact of economies of scale, as experienced in the Netherlands, PPI modelling examines the impact on individual pension pots of being invested in schemes of different sizes, based on fees and returns seen in Dutch pension schemes of different sizes. Second largest schemes are projected using UK baseline figures, as the median is around the scale of a large UK master trust, and cost assumptions are adjusted in line with the analysis from the Dutch data. Returns are also adjusted down for the smallest and up for the largest funds to simulate reduced (for the smallest) and increased (for the largest) access to investment asset classes.[45]

41 Expert informant evidence

42 Bikker, JA and Meringa, JJ (2021)

43 Bikker, JA and Meringa, JJ (2021)

44 It is worth noting that the source data used covers DB, DC and collective DC schemes but the focus on investment costs, the disaggregation by asset class and close links between Dutch and UK investment infrastructure, suggests that this evidence is relevant to UK DC.

45 Further details of the assumptions used are set out in Appendix 1

Figure 3.2: Definition of class sizes in Dutch economy of scale analysis[46]

Size	Median Size €bn	Median Size £bn [47]
Largest	44	38
Second largest	13	11
Medium sized	3.0	2.6
Second smallest	0.75	0.49
Smallest	0.25	0.21

While a small positive impact on VFM can be seen from the lower cost and higher returns of larger funds, the effect is low order, especially for Danielle who is only 1% closer to her target with the largest scheme assumptions. It is noticeable that once a scale of £0.5bn is reached, the impact of scale on reduced charges is negligible using these Dutch data, until the very largest scheme sizes are reached. The largest scheme, with a median size of nearly £40bn, does see some further gains, particularly for Max (who is 23% closer to his target), but only because of the assumed additional returns on investments in unlisted asset classes using assumptions based on Australian data (Figure 3.3).[48] No data is available from the Dutch dataset to corroborate such additional investment returns.

It is also worth noting that some costs may be outside the Dutch analysis, as these data are largely for traditional occupational schemes so some costs – for example those of governance - may be borne by the employer and not fully captured. The Dutch system may also have additional structural costs without mechanisms, such as those introduced in Australia to consolidate multiple pots.

46 Bikker, JA and Meringa, JJ (2021)

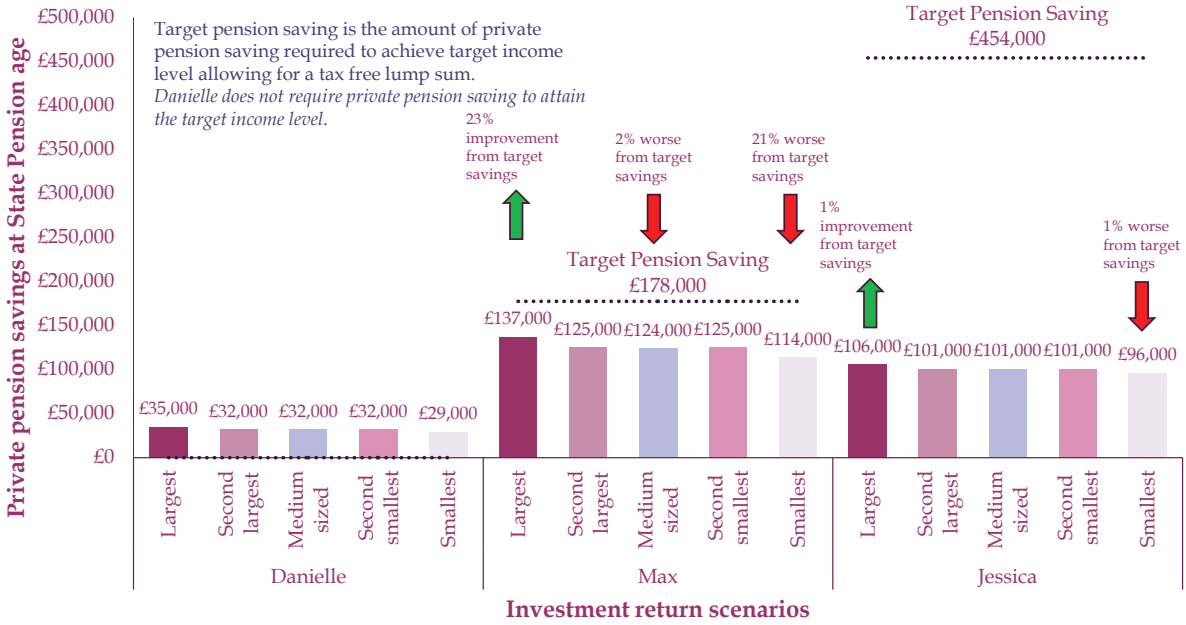
47 Calculated at €1.17 = £1

48 Based on our Australian findings – see Chapter 4

Figure 3.3[49]

Economies of scale are limited once schemes reach around £0.5bn

Private pension savings at State Pension age (SPa) before tax free lump sum, for each individual under Dutch cost data*, measured against target income replacement rates (2021 earnings)
(*Australian data for alternative asset returns)



Nevertheless, a reliance on scale effects to make substantial improvement in outcomes through cost savings beyond a modest impact for the smallest schemes may be misplaced, as the impact on VFM appears marginal based on these projections. A case for improved investment outcomes from access to wider asset types could be made, as suggested by Max's projections, but this is not supported by the available Dutch data. The modelling using Australian data suggests this is unlikely to be transformational for most members.

The provision of comprehensive data is essential for measuring the impact of changes

The above analysis is made possible by the publicly available data collected by the DNB as part of their supervisory oversight. The integrity and detail within the dataset enabled the analysis and demonstrates the underlying importance of this aspect of regulatory oversight as a tool to understand and drive VFM.

49 PPI Modelling

Lessons for the UK

Recent Dutch experience suggests that the impact of economies of scale are limited to smaller schemes

- This analysis of DNB data shows that while economies of scale can have a positive impact on costs and VFM, notably for schemes under £500m, as schemes further increase in scale, cost economies of scale run out. While administration costs continue to show further small economies, this effect is outweighed by the increase in costs associated with investing a wider range of unquoted assets to access higher risk-weighted returns.
- Assessing the overall VFM arising from such investment strategies is seen as problematic as there is insufficient robust longer-term data to verify the expected increased returns in the Netherlands.
- The conclusion that consolidating all smaller and medium-sized Dutch funds would result in cost savings of only a 1.4% (€36m or £31m) for these funds underlines the moderate cost impact of further consolidation in the Netherlands.
- Whilst the scale of Dutch provision is much greater than current UK DC, and so the UK has more opportunities for costs savings in smaller schemes, reliance on scale effects to make substantial improvement in outcomes may be misplaced.

Chapter Four: Australia – deploying regulatory benchmarking to drive Value for Money (VFM)

This chapter examines a pensions market review by the Australian Productivity Commission (APC) and subsequent Superannuation system reforms, designed to protect savers from underperforming funds

Reforms designed to make Supers 'work harder'

- Following an extensive critical review of Super funds' efficiency, competitiveness and member outcomes by the APC, the Government has adopted a regulatory benchmarking approach to assess VFM and to hold funds publicly accountable for underperformance.
- A key element of this is the use of risk-weighted investment benchmarks and tolerance tests to assess if default 'MySuper' funds are 'performing'. Underperforming funds are publicly sanctioned and can be excluded from acquiring new members.
- New tools are also being deployed by the Australian Taxation Office (ATO) designed to enable savers to rank providers, sorting them on investment returns and charges.
- These changes are supported by account stapling reforms to reduce unintended multiple account costs and bans on commissions and incentives to advisers.

Supers provide the vehicle for compulsory Defined Contribution (DC) savings in Australia

Australia has a compulsory superannuation regime in which contributions are invested in DC funds, known colloquially as Supers, that a member can take from employer to employer. Employees can choose their own Super fund or accept a default fund via their employer. Since 2011, the Government has specified a standard, low-cost product, MySuper, that must be offered by providers as a default fund.

In 2018 the APC was critical of the wide range of returns and the high level of fees levied by Super funds

The APC, in its final report at the end of 2018, concluded that while some funds achieved consistent high net returns, performance was mixed with a significant number of products underperforming, even after adjusting for differences in investment strategy. While reported fees had trended downwards, a tail of high-fee products remained, mostly in retail funds[50].

APC methodology focused on risk-weighted net returns as a VFM measure

The APC analysis compared returns, net of fees and taxes, to benchmark portfolios (BPs), constructed following industry consultation. These BPs were designed to allow comparable performance to be assessed by tailoring for funds' asset allocation. Two benchmark portfolios were constructed to assess the overall super system's performance: BP1 used listed financial market indices and BP2 extended this to blend in unlisted asset class indices. The APC considered BP2 to be more representative of super funds' implemented investment strategies and their exposure to unlisted assets classes.

50 The UK has sought to address its 'long-tail', particularly in legacy books of business, by exerting regulatory pressure through the mechanism of IGC oversight

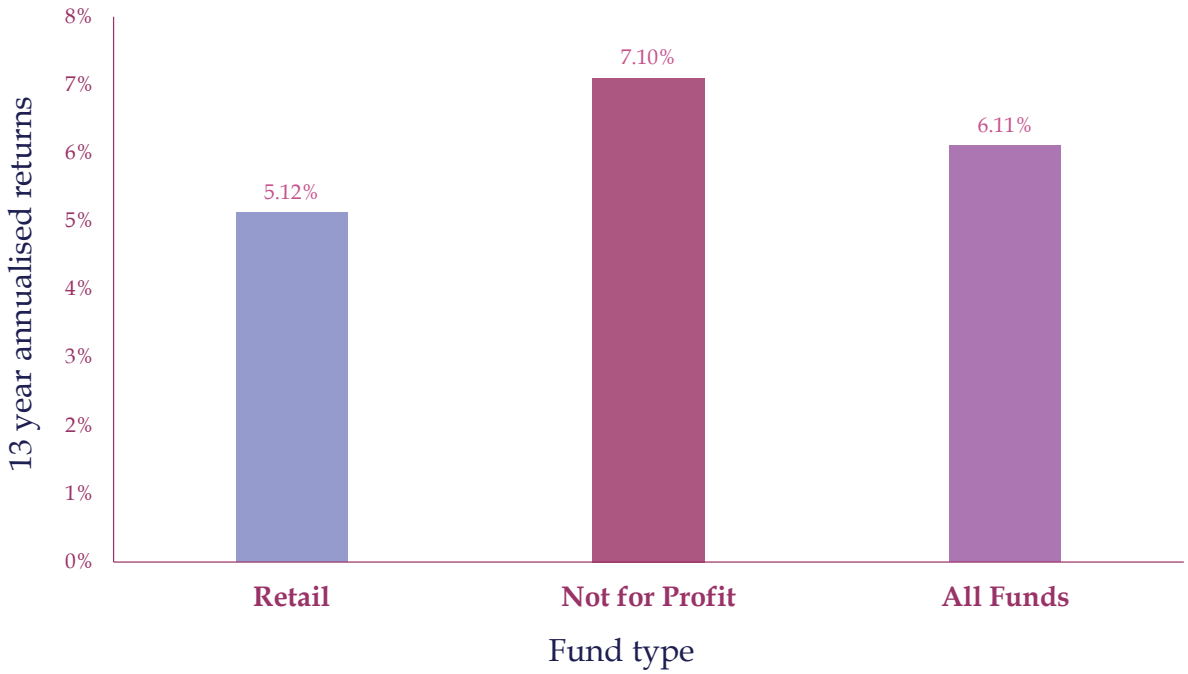
Retail funds' investment performance underperforms not-for-profit by 2% a year

Overall, the system delivered annualised net returns of around 6.1% - underperforming the benchmark by over 0.5%. But not-for-profit funds delivered returns of 7.1%, nearly 0.5% above their benchmark, while Retail funds returned around 5.1%, 1.5% below their benchmark.

Figure 4.1[51]

Australian Retail funds underperform not-for –profits

FundsAPC analysis of net investment returns benchmark adjusted to asset allocation, 2005-2017



Further analysis of the drivers of the differing returns concluded that most of the gap of -1.7% in returns for these commercial Retail funds can be attributed to poor asset selection within class. This contrasts with a positive asset selection of +0.3% for not-for-profit.[52] So, overall, there is a difference of 2% in returns attributable to investment execution.

Reforms of the system architecture recommended by the APC report

In addition to recommendations designed to improve governance and regulation, the APC recommended:

1. Funds should earn the 'right to remain' in the system using benchmark outcome tests, and
2. Members should be empowered to choose their own fund from a 'best in show' shortlist, set by a competitive and independent process

They also recommended that a member should only be defaulted once and move to a new fund only when they choose, resulting in a pot-follows-member system. [53]

51 APC (2018)

52 APC (2018)

53 APC (2018)

Your Future, Your Super reforms 'call out' poor performing funds and introduces comparison tool for members

The Australian Treasury announced reforms in response to the APC report in October 2020.[54] A key element is an implementation of net returns benchmarking as a performance test, initially for My Super funds in 2021, extending to all super funds in 2022. This performance test is performed by the Australian Prudential Regulatory Authority (APRA) using quarterly returns data on investment performance and fees.

Alongside this, the ATO has created a new comparison tool, Your Super comparison, using data from the performance tests for public use. The tool:

- Displays a table of MySuper products ranked by fees and net returns,
- Allows selection and compare in more detail up to four MySuper products at a time,
- Links to a super fund's website when selecting a MySuper product from the table,
- Shows current super accounts alongside other MySuper products, and
- Provides links to help consolidation of super accounts.[55]

An example comparison table from the tool[56] illustrates a range of returns and fee levels for a A$50,000 fund balance (Figure 4.2).

Figure 4.2[57]

Provider	Unisuper	Australian Super	Public Sector Superannuation Plan	AMG
Product	Balanced	My Super	MySuper Balanced	My Super
Investment Performance Test	Passed	Passed	Passed	Failed
Past 6-year net return	7.51%	8.1%	6.06%	5.38%
Past 5-year net return	9.15%	9.58%	7.67%	6.93%
Past 3-year net return	9.13%	8.67%	6.94%	6.75%
Total annual fee for A$50,000 balance	A$326	A$387	A$659	A$350
Investment fee	0.46%	0.63%	0.97%	0.12%
Administration Fee	2%, capped at $96 pa	$117 pa + 0.04%	$60pa	0.41%
Restricted fund	No. Anyone can access	No. Anyone can access	Yes. Specific employers only	No. Anyone can access.

Products are failed and sanctioned if net returns are more than 0.5% below the benchmark

The performance test is in two parts. The first involves the assessment of five-year investment performance relative to a benchmark portfolio created using the product's strategic asset allocation, and the second an assessment of administration fees charged in the last financial year relative to the median fee charged for the category of product. If the product underperforms the combined test by more than 0.5%, the product is deemed to have failed the test.

54 Australian Government (2020)

55 ATO (2021)

56 Available at YourSuper comparison tool | Australian Taxation Office (ato.gov.au)

57 YourSuper Comparison tool, Provider Websites

Providers of failed products are required to write to members advising them of their performance test outcome and provide details of the ATO's YourSuper comparison tool in order to enable members to review their product's performance against others in the market. If the product fails the performance test in two consecutive years, the provider will be prohibited from accepting new members into that product.[58] In August 2021, 16% of products failed the test, covering around 6% of total MySuper assets.[59]

The importance of governance

One of the harshest criticisms from the APC analysis is that of the markedly different outcomes from those saving in retail and not-for-profit products. Their analysis points to different standards of governance and suggests the scale of harm that could arise if governance is not exercised effectively and continuously on behalf of savers. It also prompts recommendations for a package of improvements in this area for the Super system.

This report explores the scale of impact of similar types of difference in governance within a UK setting if these were persistent over multiple decades of saving. Using the three vignette individuals, 13-year average net returns, adjusted for asset allocation, for not-for-profit and retail; funds are applied to the base case with a 0.4% increase in fund returns for 'good' governance, but a 1.5% decrease in fund returns for 'poor' governance.

The differences between the outcomes under the 'good' and bad' governance outcomes are marked, with Danielle receiving a pot that is two thirds larger (£14,000) under the 'good' scenario and Max more than half more, a difference of £50,000. For Max this results in pot outcome that is 25% closer to his target pension saving, but only 2% closer for Jessica (Figure 4.3).

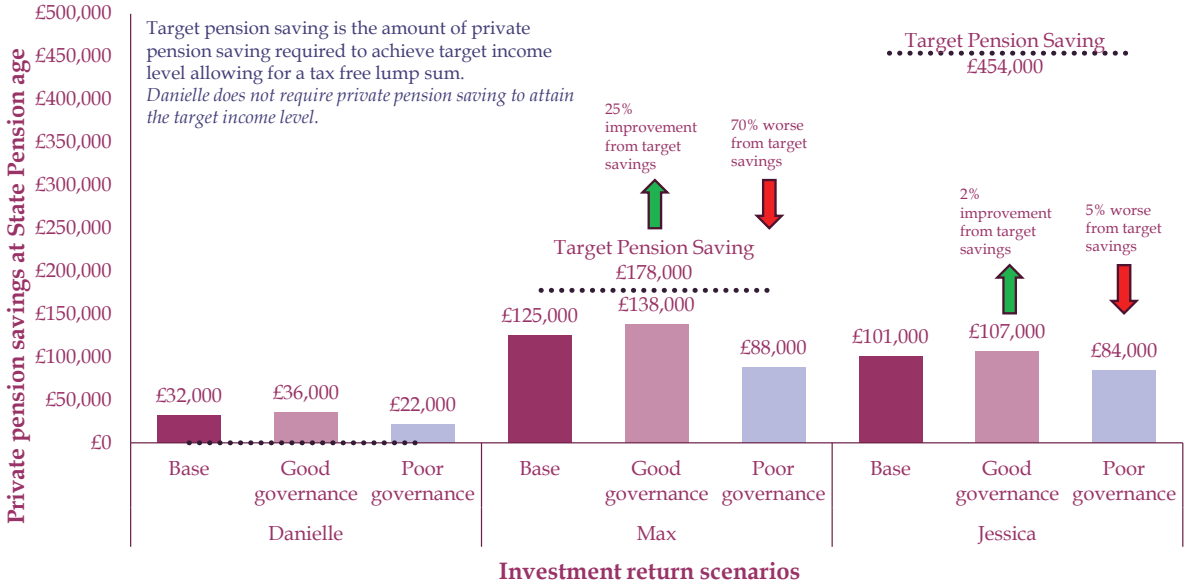
58 Roberts & Morrow (2021)

59 APRA (2021)

Figure 4.3[60]

Different governance systems can result in markedly different outcomes

Private pension savings at State Pension age (SPa) before tax free lump sum, by each individual under Australian investment returns for retail and not-for-profit governance, measured against target income replacement rates (2021 earnings)



Investing in wider asset pools appears positive but not transformative

The APC analysis simulated past performance for the two benchmark portfolios BP1 and BP2: BP1 using just listed assets and BP2 adding in unlisted assets. The difference in performance, which could be ascribed to the additional returns available through access to a wider, unlisted asset pool, is 0.8% (6.9%-6.1%) annualised over the 17-year timeseries.[61]

The effect of this uplift in returns is analysed for the three vignette individuals. The base case, constructed to reflect a large UK master trust, is assumed to have an asset mix with a wider spread than the Australian BP1, but not as wide as the large Supers that are compared against BP2. Therefore, the analysis explores the impact of a 0.4% reduction in returns from Base Case for BP1 and 0.4% uplift for BP2.

There is clearly a positive impact on outcomes arising from these additional returns. The effect on retirement pot sizes is a significant increment for all individuals, with Danielle benefiting the most proportionately with a 12.5% uplift of £4,0000 and Jessica the least with just under 6% uplift. Jessica is 2% closer to her pension target, while Max is 25% closer. Danielle has the largest proportional impact as she has the longest term of investment from age 22 to 67 prior to pot access (Figure 4.4).

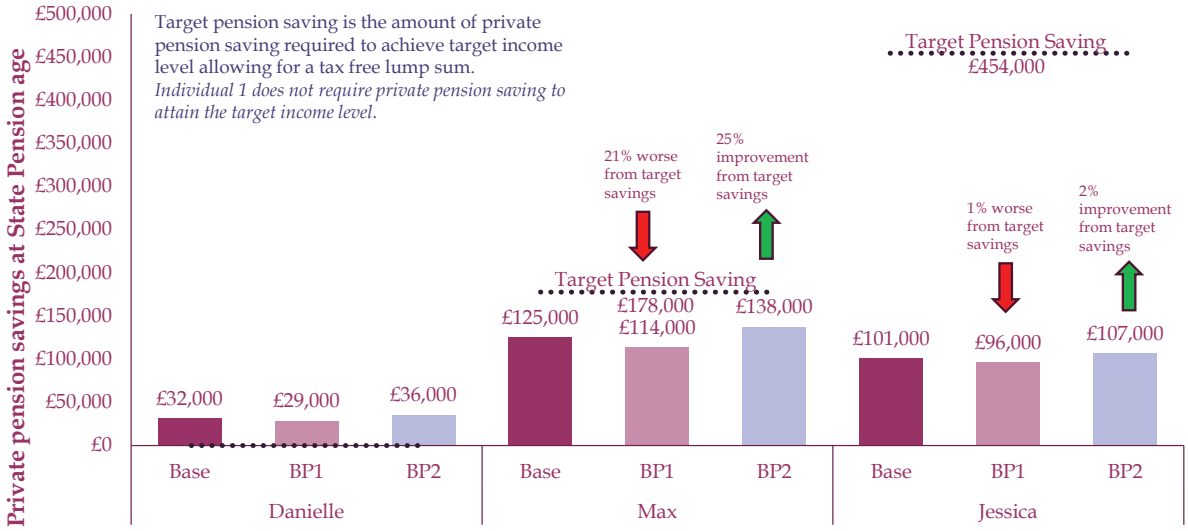
60 PPI Modelling, These are probably extreme results as the differences have been applied over the full period of retirement saving. But they do underline how governance can be overarching on its effect on VFM

61 APC (2018) p.117

Figure 4.4[62]

Alternative investments can have a positive impact on long-term returns

Private pension savings at SPa before tax free lump sum, by each individual under Australian benchmark portfolios of investment return, measured against target income replacement rates (2021 earnings)



Australian data is not directly applicable to UK asset management and returns, but, together with the caution referenced in the Dutch evidence around the additional costs involved in the use of alternative assets, this international evidence suggests that a wider asset pool has potential for a positive impact on VFM. However, expectations of transformative outcomes resulting from access to unlisted assets should not be expected based on this evidence.

62 PPI Modelling

Lessons for the UK

- The Australian evidence points to the central role of governance in outcomes for members and the strengths of Not for Profit arrangements.
- Changes to the Australian model are based on a systemic view of VFM assessed through net investment returns. It is a bold initiative to address identified harms in a mature DC system which have not been addressed so far by competitive forces and product regulation.
- A focus on benchmarking against tailored benchmark portfolios and median fees with material sanctions on funds falling below a tolerance sends a very strong signal to providers and governance as to what is expected by the system
- The stated aim to address the 'long tail' of poorly performing funds may well be achieved but could also result in a reversion to median as providers are likely to first seek to minimise the chance of failing the performance test, rather than deliver maximum risk-weighted returns appropriate to their members.
- There may be a risk that undue weight is placed on gaming the performance tests rather than optimising investment strategy, and so restricting further VFM improvements.
- It will also be important to see what impact this approach has on member service and engagement, given the secondary aim of Government to empower members to choose a high-performing and/or low-cost superannuation product that meet their needs. This may prove challenging in a system that has now implemented a 'pot-follows-member' approach which reinforces a tendency to make 'fit and forget' decisions. The design aims to mitigate this by the requirement to advise members when funds underperform. A key measure will be the number of such members who access the ATO comparison tool and then take action. Will this nudge be strong enough?
- When comparing Australian solutions to the UK, important differences in the Australian system should be borne in mind, including:
  1. Enrolment is compulsory for employees
  2. Contribution levels from employers are at a 10% minimum
  3. There is a standard default product set out by statute in MySuper, and
  4. Employees can choose an alternative provider and still receive their employer's contributions.

One other point of note is the evidence about the potential impact of alternative investments. This may be influenced by the relatively small size of Australia's listed capital markets, but suggests that the impact is relatively modest and would need to outweigh the additional cost drags evidenced in the Dutch analysis.

Chapter Five: Sweden – managing defaults and the challenges in using choice to drive Value for Money (VFM)

This chapter explores how the use of choice as a key system element in Sweden has led to poorer returns for some pension members, and how a lack of clear objectives can make it difficult to push through regulatory change.

Swedish premium pension system aims to use competition and choice to generate VFM

- The Swedish premium pension system was created in the 1990s to make higher returns possible by funnelling public pension savings into a Defined Contribution (DC) scheme invested in capital markets.
- Initial high levels of choice, driven by major promotional efforts, have not been maintained once the efforts were discontinued.
- Ambitions to engage individuals in their own pension and make choices on their own risk preferences have not been sustained, resulting in risks to outcomes.
- Well-executed defaults challenge the case for choice
- Better choice architecture has been recommended as a solution, but lack of clarity and consensus around objectives means that drives to reform have stalled.

There is clear purpose but unclear objectives in the Premium Pension

The Swedish Premium Pension (Premiumpensionsmyndigheten – PPM), launched in 2000, is a funded DC scheme that forms part of the State national retirement pension, and is now administered by the Swedish Pension Agency (SPA). Members have choice to select from up to five of around 900 external mutual funds in the system's external fund marketplace or accept the default (AP7) fund run by the SPA. Contributions are relatively small at 2.5% of income.[63]

The purpose behind the PPM was to make higher returns possible for members by investing in the capital market and to contribute to risk diversification in the national public pension. However, there was no clear objective for either the default option or the fund marketplace regarding what should be achieved in terms of returns, and what level of risk this then requires.

One crucial, yet not clearly stated, initial assumption was that savers would be active and behave with economic rationality. There were no discussions of the likelihood that savers would be able to design an appropriate portfolio by choosing from a large number of funds.[64]

Strong promotion drove initially high levels of choice

Whilst the AP7 fund was created as the default option from the outset, the Government decided to encourage investors to engage with the external fund marketplace offer and actively choose their own portfolios. This message was expressed via public pronouncements and a well-funded advertising campaign. Many of the funds also advertised extensively to attract customers.

63 Jacobson & Lundgren (2009)

64 Swedish Government (2019)

The campaign had a major impact, as two-thirds (66.6%) of the 4.4 million retirement savers chose to create their own portfolios at launch. So, the usual powerful effect of designating a default was overcome by this large-scale promotional campaign.[65]

There were marked differences in choice behaviour between cohorts depending on initial engagement effort

After the launch of the pension system in 2000, the Government reduced its advertising significantly, and so did the individual funds. By 2003, only 9.4% of new participants made an active investment choice, declining to 3.0% by 2010, and below 1% by 2016.

But the effect of the engagement efforts at launch has stayed with the initial cohort, with the defaulters in this group being six times more likely to make a subsequent active choice than in the subsequent two cohorts of 2001 and 2002. Around a quarter of the initial cohort who accepted the default fund at launch subsequently selected funds from the marketplace, while only 2.9% who initially choose marketplace funds subsequently switched to the default fund.[66] However, those invested in the marketplace did not subsequently manage their portfolios actively. The median number of switches per member over the whole period 2000-2016 was one.[67]

The default fund has proved the best option for the majority of investors

The AP7 fund was designed as largely a global equity fund with typically over 80% invested in shares, around 65% in global equities, 20% in Swedish shares and 10% in emerging markets. The balance was an equal proportion of bonds and alternative investments. Part of the currency exposure however was hedged.[68] Charges for the AP7 were low at 0.17%.

This looks like an unusually high-risk fund for a default, but it should be seen in its context. Firstly, contributions to the PPM are just under 14% of the total notional contributions of an individual to their National Pensions. The remaining 86%, forming their income pension, creates a pension entitlement financed on a pay-as-you-go basis, creating a low-risk, bond-like asset. Therefore, the higher risk element of the PPM makes up just a small proportion of the overall National Pension entitlement. Secondly, AP7 aims explicitly to achieve outcomes for those who are reluctant or unable to choose a fund manager that at least matches outcomes for those who choose a fund manager for themselves. AP7 thus effectively benchmarks itself against the best of the fund market universe and needs to follow an investment strategy that can deliver this.

An academic study of AP7 performance in 2008 concluded that AP7 was a very attractive fund: while it was outperformed by a few marketplace funds, the gains were small in comparison to the effort (and expertise) required to identify these high-performing funds. These were strong reasons to believe the typical investor was better off keeping the default option.[69]

The fund underperformed in the volatile market of the first half of 2020 with a return of 4.4%, around half the average returns from the marketplace funds. But from inception in 2000 to end 2020, AP7 had returned 292% compared to an average 131% for the marketplace.[70]

65 Cronqvist et al (2018)

66 But note that switching into the default fund was not permitted in the system until 2009

67 Cronqvist et al (2018)

68 Jacobson & Lundgren (2009)

69 Jacobson & Lundgren (2008)

70 Fixsen, R (2021)

Lack of engagement risks potential for poor outcomes and political consequences

In February 2017, the PPM was embroiled in a scandal around alleged fraud by one of the managers, Allra, who offered four funds in the marketplace. The SPA responded by stopping switches into their funds pending investigations. But, despite the well-publicised allegations, only 1.4% of PPM Investors in Allra disinvested and even a month later when Deloitte resigned as auditor and reported Allra to the authorities, only 32% of investors had disinvested.[71] This highlighted both the loose governance over participants in the marketplace and the potential for poor outcomes arising from active member choices aimed at delivering good outcomes.

Efforts to reform prove difficult to mobilise without clear objectives and political consensus

The Swedish parliament subsequently conducted an inquiry into the PPM system which recommended a two-stage reform. The initial stage, implemented in 2018, strengthened the authorisation process for funds on the marketplace with additional requirements evidencing good practice and suitability of managers, and specific authorisation of individual funds as well as the managers. The second stage was intended to be completed in 2020, designed to transform the marketplace into a procured system to increase the quality of funds offered by reducing the opportunity to select poorly managed funds.[72]

As the inquiry noted, there was an inherent tension between the State setting objectives for returns and volatility in the default system and, at the same time, giving savers freedom to choose their own levels of risk in a fund marketplace. To handle this, a clear and well-considered choice architecture that creates conditions for well-founded choices was proposed[73]. The second stage of changes are still being discussed in a working group, with pressure to water down the reforms as part of a wider political debate between the social democrats and centre-right as to the role of the State and the market in the system.[74]

71 Cronqyist et al (2018)

72 Fixsen, R (2018)

73 Swedish Government (2019), p819

74 Houman, AL (2020)

Lessons for the UK

- The Swedish example provides some interesting evidence around the challenges of using choice in the system and the potential issues for VFM.
- The initial political drive to deliver VFM through the exercising of personal choice of funds shows what can be achieved through concerted action with two thirds making an active choice. But with the withdrawal of the campaign, choice quickly fell to 10% and now just 1%. This suggests that effort needs to be both concerted and continuous. Unfortunately, there is no evidence of the actual costs involved though these were clearly significant.
- Having created a cohort of choosers, the evidence also shows that oversight is needed to protect savers from poor quality offerings - as most savers do not appear to respond to new negative information about their choices. This gives support to moves by the Australian Government to extend its performance tests to non-default funds, and also supports the actions of UK trustees and IGCs to monitor and remove funds from choice pools if they are seen to be failing to deliver expected returns.
- A particular issue from the Swedish example is the difficulty experienced in achieving sufficient political consensus in the face of vested interests to drive through reforms to construct a more robust choice architecture around the PPM. This may help to illustrate the challenges inherent for trustees and IGCs in continuous oversight of user choice facilities alongside defaults. While this is less of an issue during the savings phase, it feels particularly pertinent with the development of guided choices for access to and use of pension savings and assessment of the VFM these may deliver.
- Another interesting aspect of PPM is the design and execution of the default fund, AP7. From the perspective of UK defaults, AP7 is surprisingly adventurous in its strategy. It is largely an international equity fund that can also employ leverage and so is a relatively high-risk, high-reward fund. This seems at odds with a fund that is designed as a universal option for a basic State pension but there is logic in this strategy when seen as balancing the low-risk main income pension. The results are also impressive in the long-term despite the underperformance through the volatile markets of early 2020.

Chapter Six: The US – using the market to drive Value for Money (VFM)

This chapter explores the leakage of funds in the US workplace pension system, concerns around the use of Target date Funds (TDFs) and the importance of publicly available data for supporting VFM

The scale and power of the market presents issues differently in the US

- A key issue in the US DC system is the leakage of saved funds from corporate Defined Contribution (DC) schemes to the retail savings market
- The market exerts downward pressure on charges, but scale is still a major factor in outcomes
- The continuing shift towards Target Date Funds (TDF) to improve VFM is now being questioned
- Action in the US is largely through the courts rather than regulation
- The difficulties of securing consistent, publicly available data hampers assessment of VFM

A key issue for US DC is the 'leakage' of funds from the system

A key feature of the US DC system, apart from the lack of access to schemes for 40% of private sector workers, is that of 'leakage' of funds from the DC system: the premature spending or transfer of funds from qualifying workplace schemes for non-retirement spending.

Monies can be withdrawn from qualifying DC schemes at a 'triggering event', most typically leaving a job. This is an opportunity to claim the retirement savings for current consumption (if the value is below a certain level). Otherwise, the funds can be rolled over into a new employer's DC scheme or transferred into an Individual Retirement Account (IRA). Funds in an IRA can be accessed at any time. 22% of all funds contributed by those aged 50 and younger are removed – either at the individual's request or forced out by the scheme rules for low balances of $5,000 or less.[75]

IRAs as individual arrangements do not benefit from the purchasing power of employers. There are more assets held in IRAs than in 401(k)s (standard workplace pension schemes), with $10.3tn held in traditional IRAs in 2020.[76]

Investment charges that 401(k) plan participants incur for investing in mutual funds have declined substantially since 2000

The principal US workplace DC arrangement for private sector employees is the 401(k) plan. This market has grown from $1.7tn in 2000 to $6.7tn in 2020 in terms of assets under management. Two thirds of these assets are now invested in mutual funds, around 60% of these are equity funds.

The market has delivered substantially lower fees through competition over this period as funds under management have grown. The investment fees for employees holding equity funds in 401(k) plans has reduced from 0.77% in 2000 to 0.39% in 2010. Similar reductions have been recorded for bond funds (0.60% to 0.32%).

75 Rhan, M (2021

76 Norrestad, F (2021)

These fees also show an appreciable discount to those paid by ordinary investors, with the average investor paying 0.50% (0.11% more) for equity funds and 0.42% (0.10% more) for bond funds.[77]

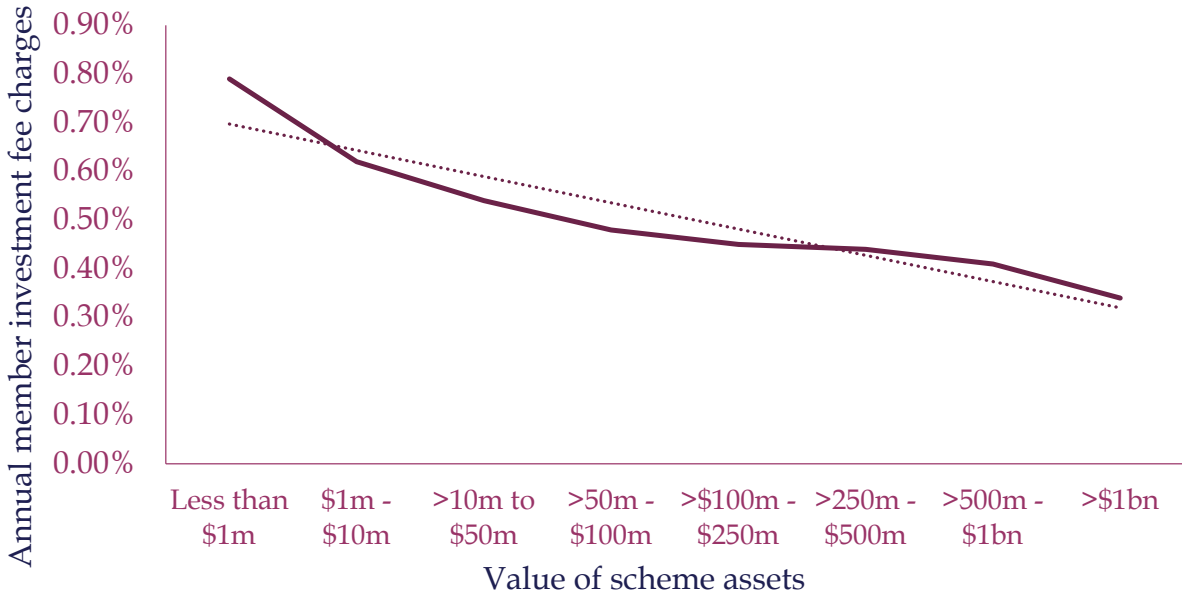
There are significant reductions in fees paid as 401(k) plan size increases

The proportion members pay in fees reduces significantly with plan size, with investment fees of 0.79% for the smallest schemes more than halving to 0.34% for schemes with $1bn or more invested (Figure 6.1).

Figure 6.1[78]

Investment fees paid by 401k members fall by half as scale increases

Asset-weighted average expense ratio as a percentage of plan assets in US domestic 401k equity mutual funds, 2017



The use of Index Funds and TDFs are increasingly used to drive VFM

401(k) plan investors are increasingly using index funds, which track an investment index, and the proportion of 401(k) assets invested in index funds rose from 17% in 2006 to 36% in 2017.[79] US index funds are now five times cheaper than active funds, with average asset weighted fees of all passive funds at 0.12% in 2020 compared with 0.62% for active.[80]

The move to cheaper passive funds has not brought a consequent reduction in investment returns relative to active management. In general, actively managed funds in the US fund market have failed to survive and beat their benchmarks, especially over longer time horizons; only 23% of all active funds topped the average of their passive equivalents over the 10-year period to December 2020.[81]

The coronavirus sell-off and subsequent rebound in 2020 tested the argument that active funds are generally better able to navigate market volatility than their index equivalents. Active funds' performance through the first half of the year showed that there was little evidence to support this view, with 51% of active funds both surviving and outperforming their average index equivalents during the first half of the year.[82]

77 ICI (2021)
78 Brightscope Defined Contribution Database and Morningstar
79 Brightscope & ICI (2020)
80 Johnson, B (2021a)
81 Johnson, B (2021b)
82 Johnson, B (2021b)

The use of TDFs has also increased. TDFs gradually change their asset mix to reduce the investment risk over a period of five to 10 years as the target retirement date approaches, to give increased certainty (or 'lock in') capital when funds are due to be drawn. In 2006, 3% of 401(k) plan assets were invested in TDFs. This had risen to 24% by 2017[83].

Concerns are now surfacing over the VFM of TDFs

Concerns has been voiced over the marketing and use of TDFs. This is of particular concern as they are now often the plan's designated default (QDIA[84]) fund and are not actively selected by plan participants.

Critics claim that many fiduciaries responsible for selecting their plan's TDFs don't understand how these funds work. New products, such as TDFs, that provide lifetime income options or make private equity investments are becoming available. TDFs can also invest in real estate, private equity and other alternative investments that fiduciaries need to evaluate, and some funds have significant equity exposure even after participants are assumed to have retired.

Alternative QDIA choices include balanced funds, which have a consistent mix of equites and fixed interest investments over time, are considered easier to understand and explain, have long performance histories and are likely to have lower fees than TDFs[85].

Lawsuits challenging TDF selection are reported to be on the rise and fiduciaries are being advised to:

- Make sure that the plan's investment policy statement includes provisions on selecting and monitoring TDFs.
- Compare the proprietary TDFs offered by the financial firm providing administrative services to the plan with other available alternatives.
- Understand the different fees and compare fund family fees, bearing in mind that TDFs have multiple layers of fees.[86]

In response to concerns, the US Government Accountability Office (GAO) has been asked by the US Senate to review the use of TDFs in 401(k) and similar DC retirement plans. The Senate expressed concerns that recent regulatory changes had paved the way for the use of potentially higher risk and more lightly regulated alternative assets, such as private equity, and that little is known about the extent to which TDFs offered in employer-provided retirement plans include alternative assets, and how those TDFs with alternative assets impact participants' fees and returns.[87]

There are increasing legal challenges for trustees on fees

Another growing area of litigation in the US DC market concerns the filing of excessive fees litigation under the Employee Retirement Income Security Act (ERISA) against DC plan fiduciaries. Historically, these claims have been filed against only the largest organisations, but there has been a significant surge in litigation in the last five years targeting a broader range of plans, despite the evidence that average plan fees have been falling steadily.[88] More than 30 claims have been settled for more than $10m.[89] Nearly 100 cases were reported as filed in 2020.[90]

A key trigger was a Supreme Court ruling in 2015 confirming the continuing duty of prudence for fiduciaries to monitor their plan's investments so that claims are not barred by ERISA's six-year statute of limitations. The lawyers arguing this case have made a series of such claims. against university funds, with at least 20 Universities sued since 2016.[91]

83 Brightscope & ICI (2020)
84 The QDIA acronym stands for Qualified Default Investment Alternative
85 Buckman, C (2021)
86 Buckman, C (2021)
87 Miller, S (2021)
88 Godbout, T (2020)
89 LaCroix, KM (2021)
90 Marwitz, CJ (2021)
91 Adams, JD (2021)

Mitigating actions to reduce fiduciary liability that are recommended include:

- Establishing, following and documenting a "robust and prudent process" for retaining recordkeepers and determining their fees, as well as for selecting and regularly reviewing plan investments and investment expenses;
- Retaining qualified, independent experts to assist with fiduciary decisions; and
- Documenting the process and rationale behind any fiduciary decision, being "particularly meticulous" when deciding to use more expensive products or services, or when going against expert advice[92].

It would therefore appear that the actions of the US courts are resulting in trustees having to apply similar governance and recording disciplines as are required through regulatory action in the UK.

There are also problems with US data sources

Another aspect of the US DC market are the issues around obtaining consistent, publicly available data on schemes. While schemes are required to make individual disclosure of the charges and fees to their members, there are problems assembling and interpreting summary information from data returned to the US Department of Labor (DoL).

As a result, third parties have been relied upon by researchers and advisors as sources of collated and analysed data. These are typically proprietary industry or commercial sources often subject to costs and restrictions. Entrepreneurial businesses, such as BrightScope, have been set up to meet data needs. BrightScope, now acquired by ISS, offer a database of DC Plans as market intelligence for sales and client managers in asset managers. It also compiles annual rankings of 401(k) plans, rating them for outcomes using factors such as contributions, returns fees and participation[93].

Access to such proprietary data may well be necessary for evidence to carry out enquires such as that commissioned by the Senate from the GAO as well as for cases brought before the courts[94].

Lessons for the UK

- The assessment of VFM in the US is primarily driven by the markets and the courts. The key public policy issue concerns leakage, and, while this has a broader VFM aspect, it is largely outside the jurisdiction of the workplace pensions environment. The UK needs to be watchful for parallel issues with access and the development of consolidators who may take accrued funds out of the trust-based regulatory oversight into the retail market.
- It is worth observing that while the market does bear down on costs, the spread is wider than in the UK, as there is no regulatory cap and other policy interventions which have been effective interventions in the UK. It will be interesting to see whether the court actions will result in tacit consensus on VFM metrics or whether pressure will be put on the DoL to put a regulatory framework around these issues in place to curb the flow of class actions and the uncertainty surrounding necessary and sufficient trustee actions.
- The current sense is that DoL and EBSA are not in a position to drive policy, as they are focussed on rebuilding their organisation after neglect under the previous administration. A key step may be to grab control of the narrative around the numbers - as other countries have done - if they wish to get ahead of the market and potential political fallout on issues such as excessive fees and VFM in TDFs. The UK is much more active in this area.
- One final point worth noting is the moves towards indexation and consolidation still has some way to travel in the US market.

92 Godbout, T (2020)

93 Zulz, E (2018)

94 U.S. Government Accountability Office

Conclusions

Our key conclusions are set out in the Executive Summary at the start of the report. This shows that Value for Money (VFM) in pensions has been addressed in a variety of ways in countries with growing DC systems. Each jurisdiction has its own specific context and has taken differing approaches to drive VFM in their systems. These can suggest ways in which the current UK debate might be challenged or expanded, but also that there may be common elements to a framework that could be set around the assessment of VFM to aid evaluation and policy development.

Appendix One: Modelling technical appendix

Overview

The purpose of the modelling is to illustrate the key findings from the report with quantitative impacts. Providing vignettes in the model allow each scenario based upon international evidence to be applied to a range of representative individuals. This illustrates the relative impact of each scenario on the vignettes. Projections have been made using the PPI's Individual model.

Under each scenario, an indicative income and pot size at retirement are projected to quantify the impact on their private pension saving in accumulation. Each individual has a unique lifecourse to illustrate the different scenarios on individuals who are representative of the target demographic of master trusts offering automatic enrolment pension provision. The pot size and pension income, split into its components (State, private pension, benefits, and income tax), for each investment strategy is compared to the base projection.

The base projection

The base projection for each vignette reflects pension scheme features of investment strategies representative of large UK master trusts. Individuals modelled in this report reflect typical characteristics of members of master trusts, typical of their age, their salary and their contribution patterns.

The economic assumptions and investment returns have been set in line with the Office for Budget Responsibility's (OBR) forecast from the Economic and Fiscal Outlook (EFO)[95]. A representative asset allocation for current industry default funds has been used in the model. This equates to a 69:19:2:10 equity: bond: cash: other investment ratio (other assets include property and commodities).[96] A 10-year de-risking glide path was modelled to reach the average asset allocation for common retirement funds found in industry. This equates to a 24:59:11:6 equity: bond: cash: other investment ratio. The de-risking process began 10 years prior to retirement. The glide path follows a linear progression between the default funds and retirement funds currently available in the pensions industry.

Results and metrics

Replacement rate income targets

Pensions Commission target replacement rates

This measure looks at whether an individual can achieve a standard of living comparable to the standard of living the individual had before retirement. This approach was used by the Pensions Commission in 2005.

95 Office for Budget Responsibility (2021), Economic and fiscal outlook – March 2021

96 PPI calculations based upon fund factsheets for default funds found in industry. The average asset allocation has been taken to give a representative default fund.

The adequacy thresholds and respective replacement rates are shown below:[97]

Pre-retirement gross earnings (2004)	Pre-retirement gross earnings (2021)	Replacement rate threshold
< £9,500	< £14,100	80%
£9,500 to £17,499	£14,100 to £25,999	70%
£17,500 to £24,999	£26,000 to £37,199	67%
£25,000 to £39,999	£37,200 to £59,599	60%
£40,000 or more	£59,600 or more	50%

Pre-retirement gross earning thresholds have been updated using earnings inflation.

Pot size at retirement

The value of the pot size at retirement, before the lump sum has been taken, was computed for each benchmark and scenario. This is reported in current (2021) earnings terms.

Pot size index

The value of the pot size at retirement has been indexed against the base scenario for each individual. The index is calculated such that the index under the base scenario for each individual is set equal to 100.

Income in retirement

Total income after income tax immediately after retirement has been projected for each individual. This is reported in current (2021) earnings terms. Income has been split into components (State pension income, private pension income, benefit income, income tax). This is shown to give the relative differences in pension income received at retirement and the extend at which they exceed (or fall short of) income targets.

Individuals

The key features of the representative individuals are:

Danielle – Danielle is a low-earning woman who works part time throughout her working life, age 18 to State Pension age (SPa). She is aged 22 in 2022 and earns £12,000pa. This is based upon working part-time (3.5 days per week) at the National Living Wage (NLW), and she is assumed to maintain these working hours at NLW throughout working life. She contributes to a Defined Contribution (DC) pension, with her employer, at automatic enrolment minimum contributions (8% of band earnings) until SPa.

Max – Max is a low-earning man, (close to the 30th percentile for age and sex) who works full time throughout his working life, age 18 to SPa. He is aged 32 in 2022 and earns £25,000pa, he is assumed to follow an income trajectory consistent with 30th percentile earners). He contributes to a DC pension, with his employer, at 8% of whole earnings until SPa.

Jessica – Jessica is a typical earning woman (around median earnings for age and sex) who has previously worked full time, however has currently withdrawn from the labour market to care for family. She is assumed to return to full-time work at age 50 and continue to work until retirement at SPa. She is aged 42 in 2022 and has indicative earnings of £35,000pa (where she is currently working). She has retained DC pension savings associated with previous employment of £15,000 (typical for age and gender)[98], and on returning to employment contributes to a DC pension, with her employer, at 12% of whole earnings when in work.

These lifecourses are based on typologies identified within the WHERL project.[99]

97 Pensions Commission (2005)

98 Office for National Statistics (ONS) (2019), Pension wealth: wealth in Great Britain, Table 6.8

99 WHERL (2017) *The Wellbeing, Health, Retirement and the Lifecourse Project*

Behaviour at retirement

At retirement individuals withdraw 25% of their pension wealth as a tax-free lump sum at retirement, then draw an income from their remaining wealth, initially at a rate of 3.5% of their pension wealth and increasing the amount in line with the Consumer Price Index (CPI) until they have exhausted their pot.

This gives an indicative income to quantify the impact of their private pension saving in accumulation. Each individual has a unique lifecourse to show the impact of different investment strategies on representative members of a large UK master trust.

Assumptions

Key assumptions

Except where explicitly stated in the report, the key assumptions used in the report are detailed below.

Pension scheme assumptions

All individuals are assumed to be invested into a DC scheme from a large master trust. Individuals have no accrued Defined Benefit (DB) benefits.

Charges

The pension scheme is modelled with an annual charge of 0.5% of funds under management.

The pensions system

The pensions system modelled is as currently legislated. The triple lock is assumed to be maintained. Individuals are assumed to be members of a DC scheme.

Other economic assumptions

Other economic assumptions are taken from the OBR's EFO[100] (for short-term assumptions) and Fiscal Sustainability Report[101] (for long-term assumptions).

International scenarios

The scenarios modelled are as follows:

Australian benchmarks

Investment returns for BP1 are 0.4% lower than the base case. BP2 represents a 0.4% increase in investment return over the base case. This is also used to represent good governance in the industry, whilst poor governance is reflected with a 1.5% decrease compared to the base case. The benchmarks applied to both historical and future returns for each individual.

Dutch benchmarks

Investment strategies are split into five classes, each with different returns and AMC. This is based on the investment portfolios of five Dutch funds which are of different sizes. Class 2 is equivalent to the base case. The classes are constructed as follows:

- Class 1 – 0.53% AMC with BP2 returns
- Class 2 – 0.50% AMC with Baseline returns
- Class 3 – 0.54% AMC with Baseline returns
- Class 4 – 0.51% AMC with Baseline returns
- Class 5 – 0.50% AMC with BP1 returns

100 Office for Budget Responsibility (2021), Economic and fiscal outlook – March 2021

101 Office for Budget Responsibility (2020), Fiscal sustainability report – July 2020

Baseline returns follow investment returns outlined in the base projection (found earlier in the appendix). Investment returns for BP1 are 0.4% lower than the baseline returns. Investment returns for BP2 is 0.4% higher than the baseline returns.

Superfunds

Australian superfunds are modelled by altering the Annual Management Charge (AMC), the fixed fee and the investment return. The fixed fee is converted into Pounds Sterling using current exchange rates. Investment returns are applied to both historical and future returns. Details of the four superfunds are shown below:

- UniSuper – 0.46% AMC + £50.88pa with an investment return of 7.97%
- AusSuper – 0.67% AMC + £62.01pa with an investment return of 8.73%
- PSSap MySuper – 0.97% AMC + £31.80pa with an investment return of 7.03%
- AMG MySuper – 0.53% AMC with an investment return of 5.5%

New Zealand benchmarks

Glide paths for each individual are changed to represent the most aggressive and most conservative investment strategy chosen. The same 10-year glide path is used as in the base case. The most aggressive default fund is chosen by observing the asset allocation of the default fund which carries the most risk. Their respective retirement fund is chosen as the fund at which the default fund de-risks towards.

Default fund	Cash	Equity	Gilts and bonds	Other
Most aggressive	0%	90%	0%	10%
Most conservative	2%	41%	44%	12%

Retirement fund	Cash	Equity	Gilts and bonds	Other
Most aggressive	0%	27%	72%	1%
Most conservative	0%	0%	100%	0%

New Zealand contributions

To measure increases in engagement, contributions increase for each individual to show the impact on the pension fund and pension income. Total contribution rate increases by 2%, 4% and 6% to reflect different levels of engagement in the model.

The PPI Individual Model

The Individual Model is the PPI's tool for modelling an illustrative individual's income during retirement. It can model income for different individuals under current policy or look at how an individual's income would be affected by policy changes. This income includes benefits from the State Pension system and private pension arrangements, and can also include income from earnings and equity release. It is useful to see how changes in policy can affect individuals' incomes in the future.

The PPI's Individual Model calculates streams of retirement incomes for constructed individuals. The streams of income include State Pension, private pension and various state benefits in retirement. The individual model uses flexible policy parameters to define the pension landscape throughout the individual's working-life and retirement. The individual is constructed by setting out the work history in terms of working patterns and salary level throughout their working-life, along with pension scheme membership details.

The modelling conducted in this report is deterministic.

Application of output

The model is best used to compare outcomes between different individuals, policy options, or other scenarios. The results are best used in conjunction with an appropriate counterfactual to illustrate the variables under test.

Limitations of analysis

Care should be taken when interpreting the modelling results used in this report. In particular, individuals are not considered to change their behaviour in response to investment performance. For example, if investments are performing poorly, an individual may choose to decrease their withdrawal rate and vice versa.

Key data sources

The specification of a model run is based upon three areas:

The individual

The individual to be modelled is specified based upon an earnings and career profile. Saving behaviour for private pension accumulation is considered, as well as the behaviour at retirement.

These are generally parameterised according to the project in question, designed to create vignettes to highlight representative individuals of the groups under investigation.

The policy options

The policy option maps the pension framework in which the individual exists. It can accommodate the current system and alternatives derived through parameterisation. This allows flexing of the current system to consider potential policy options to assess their impact upon individuals under investigation.

This area has the scope to consider the build-up of pensions in their framework, such as the automatic enrolment regulations for private pensions and the qualification for entitlement to State benefits.

The framework in retirement allows for the tax treatment and decumulation options taken by the individual, as well as other sources of State benefits which influence the post-retirement outcomes for individuals.

Economic assumptions

The deterministic assumptions used in this analysis are taken from the OBR's EFO to ensure consistency. They cover both historical data and future projected values.

Fund factsheets

Asset allocations of funds from workplace pension providers were used to determine the progression and length of the de-risking process prior to retirement. Asset allocations were also compiled to determine the average asset allocation for certain types of funds available in industry.

Appendix Two: KiwiSaver review – Minimum Member Engagement Standards

Source: MBIE (2020b)

Provider service	Description	Service standard
Onboarding	All new default members receive access to an on-boarding advice process covering fund choice, contribution rate and checking contact details.	Within three months of being allocated to the provider, at least: (a) 50% of members engage with the onboarding process (for example, opening emails, updating contact details, downloading a provider app). (b) 20% of members complete onboarding via an advice conversation or through engaging with digital tools (for example, completion of a fund profile tool, using a savings calculator).
First home withdrawal check-up	All members who withdraw funds for a first home receive a check-up to discuss the value of continuing contributions and to check fund choice.	Within three months of withdrawing funds for a first home, at least: (a) 50% of members engage with the first home withdrawal check-up (for example, opening emails, contacting the provider for personal advice). (b) 20% of members complete the check-up via an advice conversation or through engaging with digital tools (for example, completion of a fund profile tool, using a savings calculator).
Pre-retirement check-up – 10 years out	All members turning 55 receive a 10-year out check-up covering contribution rate, fund choice, and an introduction to the options available when they reach eligibility age.	Within three months of a member turning 55, at least: (a) 50% of members engage with the 10-year out check-up (for example opening emails, contacting the provider for personal advice). (b) 20% of members complete the check-up via an advice conversation or through engaging with digital tools (for example, completion of a fund profile tool, using a savings calculator, use of an options tool).

Pre-retirement check-up – one year out	All members turning 64 receive a one-year out check-up covering contribution rate, fund choice, and an introduction to the options available when they reach eligibility age.	Within three months of turning age 64, at least: (a) 50% of members engage with the one-year out check-up (for example, opening emails, contacting the provider for personal advice). (b) 20% of members complete the check-up via an advice conversation or through engaging with digital tools (for example, completion of a fund profile tool, use of an options tool).

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