PPI report, DC asset pooling – launch write up

The Pensions Policy Institute (PPI) held a policy seminar on 8th November 2017 to launch its research report: ***The impact of DC asset pooling: international evidence,*** sponsored by Schroders.

The report sets out the available evidence from international examples of DC pooling and exploring the impact this could have for members of DC schemes in the UK.

52 people representing a broad range of interests within Government, the investment industry, the pensions industry and the third sector attended the seminar.

Gavin Ralston, Head of Institutions and Thought Leadership, Schroders, thanked the PPI for their work and welcomed the attendees and outlined why Schroders were keen to sponsor the report.

Chris Curry, Director, Pensions Policy Institute gave the Chair's welcome and noted that the publication of the research had conveniently fallen within the period of DWP's consultation on bulk transfers made without members' consent.

Sarah Luheshi, PPI Deputy Director and Lauren Wilkinson, PPI Policy Researcher, presented the findings of the Research.

Lesley-Ann Morgan, Global Head of DC and Retirement, Schroders made three main points:

1. If outcomes are to be improved for DC savers, this will necessitate a drive towards consolidation.
2. Industry and policy-makers need to investigate how to improve opportunities for schemes to increase scale and improve investment approach and governance.
3. Schemes need to be encouraged to use a wider range of asset classes particularly ones with reduced liquidity, increase opportunities of return and reduced volatility.

David Farrar, DC Policy Lead – Investment, Governance and Charges, Department for Work and Pensions said that the Government was more interested in removing barriers to consolidation than confronting schemes about their current investment approaches. He didn't think it would be necessary to mandate consolidation as it is happening anyway. There is already high demand from schemes, and organic development is likely to lead to better outcomes for members.

He noted that many people assume that the benefits of scale related to improved governance, but said, in fact, the main benefits arise from large schemes having better negotiating positions. It should not be assumed that decreasing charges will have the most positive effect on pension outcomes; the ability to negotiate good deals and investment strategies could lead to overall better returns which compensate above and beyond charges.

He was not sure whether the case had been fully made that consolidation leads to improved outcomes.

He did not agree that the charge cap was a barrier to pooling as there was not much large scale investment prior to the cap and those who were investing in more consolidated way did not cease to do so after the cap was introduced.

He discussed the current consultation on introducing a scheme test for bulk DC to DC Transfers. This could potentially involve schemes needing the approval of an independent adviser that the proposed transfer was in the best interest of members, unless the receiving scheme was an authorised Master Trust. However, he felt that there would need to be a mechanism by which trustees were not absolved from all responsibility for their decisions made whilst in charge of the scheme, once a transfer has been made.

Chris Curry led a panel session, during which the following points were raised. The discussion does not reflect or represent the view of the PPI.

Charges

- The charge cap does not directly discourage consolidation but highlights that there is a lot of pressure on value for money which could, in turn, encourage schemes to focus on less expensive instruments which might lead to less consolidation and less use of alternative asset classes.
- One option would be to require schemes to consolidate if their charges are above a certain level.

Outcomes

- Charges don't cover only investment management, they pay also for admin, communications and other incidentals. Therefore, it does not make sense to focus just on charges. It would be more helpful to focus on why people are not achieving the outcomes that they expect. Will pooling help people to achieve better outcomes? And how do we define "good outcomes"?
- Most schemes aren't clear about what they are trying to do - schemes could be required to define "good outcomes" for their members and then to prove that they are working towards delivering those.
- Evidence shows that most members define good outcomes as "an outcome which delivers the lifestyle in retirement that they are expecting". This could form the basis of an outcomes test.

Daily pricing

- One barrier to consolidation and use of less liquid assets is that schemes are attracted to using assets with daily pricing as it makes day-to-day management and costing easier, and members like to know the value of their investments on a regular basis. Perhaps when automatic enrolment is fully rolled out and schemes have a better idea about future membership and contribution levels they may feel more comfortable about using less liquid assets.
- Another barrier is automatic enrolment regulations and guidance regarding safe scheme operating which discourages less conventional investment decisions.
- It would be helpful for government to remove barriers and help encourage supporting infrastructure to be put in place. Industry can move away from daily pricing organically as has been seen in the Australian example. Other countries which have not shown similar trends have also had their industries more hindered by regulation.

The following points were raised during the question and discussion session held under the Chatham House rule, chaired by Chris Curry, with the panellists, David Farrar (DWP), Tim Horne (Schroders), Laurie Edmans (Zurich IGC), and Lauren Wilkinson (PPI), and the audience. They do not necessarily reflect the views of the Pensions Policy Institute:

Charges, administration and inefficiency

- While there is recognition that charges are not the only variable affecting outcomes, charges are still very important and small schemes (particularly older, legacy schemes) can significantly improve outcomes by reducing charges. In automatic enrolment schemes, which are generally under the charge cap, reductions in charges won't have as much of an effect. While reducing charges in international schemes had a major impact, many of these schemes started out with very high costs.
- Flat fees are part of the problem with legacy schemes and should be avoided.
- Having low cost funds is not as effective in producing good outcomes as having engaged members and good returns. Communications, at an individual level, are critical to aid better engagement. Larger schemes will find this easier.
- If higher returns and contributions have a major impact on final outcomes, how do we balance the need for low costs against the need for better investment strategies?
- There needs to be more investigation of charging. It can't be assumed that higher charges are always due to inefficiency.
- There is a clear negative correlation between charges and scheme size which suggests that smaller schemes may be less efficient. Small schemes may also be making less sophisticated investment decisions

- What size does a scheme need to be in order to work efficiently within the charge cap? This number is likely to be around 50,000 members.
- In 1997, the average charges born by members were around 1.5%pa, but return promises were also higher in those days, for example: RPI + 5%. Return expectations are far lower now and therefore charges should be lower. Importantly, returns are still above inflation.

Investment

- Lots of markets have more constant prices than found in the UK market. It should not be too difficult to institute more constancy in pricing, however there is some confusion between daily pricing and holding periods.
- Can less liquid assets be made easier for trustees to access/understand?
- Pooling need not be just between schemes, schemes can pool within their own investments (e.g., L&G). But how can this type of pooling be facilitated? Does government need to persuade industry? Would it help for pension schemes to come together and hire managers to orchestrate more investment pooling?
- It would be sensible for government to set up the necessary infrastructure, but if they publicly endorsed pooling they would be in the sticky position of telling schemes how to manage their investments and may be held responsible if things go wrong.
- The use of illiquid assets with higher returns to and through retirement will be especially appropriate for those who go into drawdown, as long as sufficient funds are maintained in liquid assets and therefore available to draw down.
- Problems with investment decisions are really a governance issue. But how can the bar on governance be improved? In small businesses, governance is often at the employer level, but a high proportion of SMEs want only to comply with the minimum regulations.
- It is not clear that all passive investing is bad or that all active investing is good. There needs to be an appropriate balance between passive and active which can deliver optimal outcomes. Schemes should aim to invest in multi-asset funds which avoid volatility, reduce charges and help deliver a more guaranteed level of return.
- Risk management is more important than whether investments are actively or passively managed. The importance of risk management will vary between people.
- Schemes should avoid "group think" and not assume that there is one appropriate way of managing funds which will suit all members.
- In Mexico, people are put into funds with different volatility levels depending on their age, though they are moving away from this model and towards a life styling approach.
- Schemes are encouraged by the regulator to use investment platforms and it is helpful for schemes to interact with only one entity. However, platforms often restrict access to less conventional assets or investment in social enterprises and tend to focus on assets which use daily pricing.

There are no direct barriers for platforms to use assets which are not priced daily, but daily priced assets make record keeping and reporting easier.

- On the other hand, platforms will increase the numbers of people invested in particular assets which is in itself, a form of pooling.

Scheme consolidation

- NEST has been helped by the introduction of other Master Trusts, as these schemes have all been able to learn from each other.
- A clear optimal scheme size for charging efficiency would be helpful. It would also help to drive consolidation as schemes below this size could be encouraged to consolidate with each other.
- Scheme performance is not just about size – the knowledge and understanding of trustees is also a vital element.
- Consolidation would allow regulators to take a more active role (as there would be fewer schemes) and would pave the way for more interventionist regulation which would help to prevent problems in advance.