Pensions Policy Institute

PPI

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

Executive Summary

The Pensions Policy Institute (PPI)

The PPI is an educational, independent research organisation with a charitable objective to inform the policy debate on pensions and retirement income provision. The PPI's aim is to improve information and understanding about pensions and retirement provision through research and analysis, discussion and publication. It does not lobby for any particular issue or reform solution, but works to make the pensions and retirement policy debate better informed.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects.

Pensions affect everyone. But too few people understand them and what is needed for the provision of an adequate retirement income. The PPI wants to change that. We believe that better information and understanding will lead to a better policy framework and a better provision of retirement income for all. The PPI aims to be an authoritative voice on policy on pensions and the provision of retirement income in the UK.

The PPI has specific objectives to:

- Provide relevant and accessible information on the extent and nature of retirement provision
- 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.

We believe that the PPI is unique in the study of pensions and retirement provision, as it is:

- Independent, with no political bias or vested interest
- 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

www.pensionspolicyinstitute.org.uk

The future is ever changing, but the PPI remains a constant "Voice of Reason" in the ongoing debate on the future of retirement in the UK.

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This report has been authored by:

Nick Hurman – Research Associate

Nick is an independent strategy and research specialist and previous author for the PPI. Nick has 20 years' experience as a senior industry executive in pensions and financial services with companies such as AEGON, NPI, SAGA, London Life and Legal and General. He has run his own consultancy for 15 years specialising in research and policy work to enable consumers to achieve better outcomes in their engagement with UK financial services. His work has been mainly with public interest groups and trade bodies and much has been published and presented in research and industry forums.

Nick is a Fellow of the Chartered Insurance Institute. He holds an MBA in Insurance and Risk Management from City University Business School and a BSc from University College, Durham.

Chetan Jethwa – Policy Modeller

Chetan Jethwa joined the PPI modelling team in April 2018 as a Policy Modeller. He is responsible for maintaining and developing PPI models as well as producing modelling results and undertaking analysis to feed into the PPI's research.

Chetan has a BSc in Actuarial Science from the London School of Economics.

Daniela Silcock – Head of Policy Research

Daniela is Head of Policy Research at the Pensions Policy Institute (PPI), and she leads the PPI Policy Research team. She has a wealth of experience in conducting quantitative and qualitative research into all aspects of state and private pensions policy, writing articles for journals and national press, and presenting to a variety of domestic and international audiences, including radio and television appearances.

Daniela originally joined the PPI in 2008 and took a short break in 2012 to work as a Committee Specialist for the Work and Pensions Select Committee.

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.

Tim Pike – Head of Modelling

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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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)*

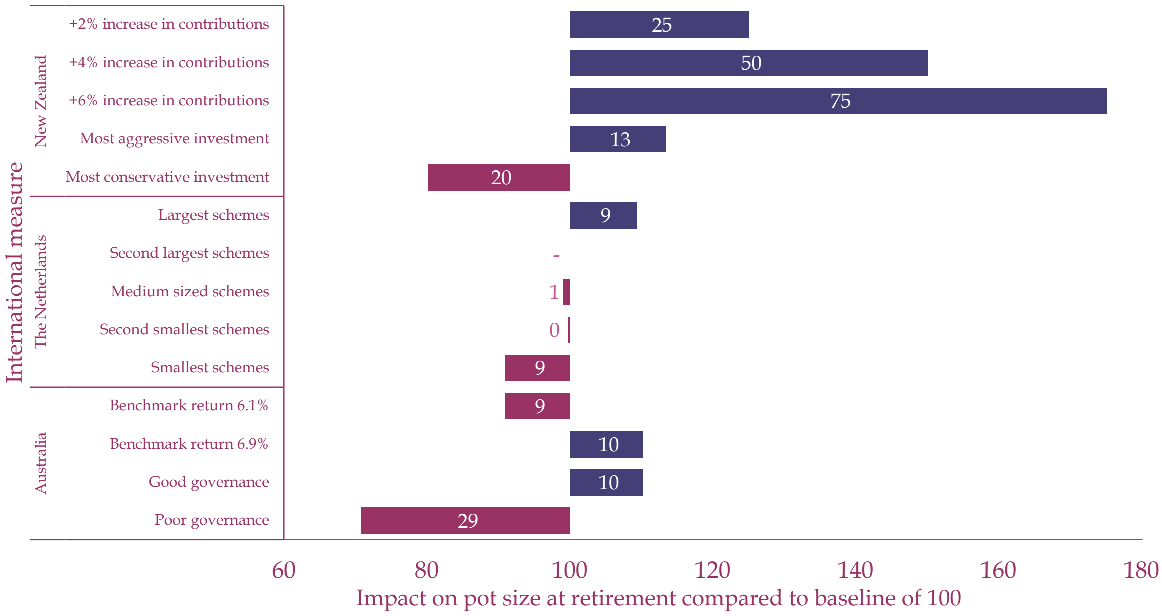
The following emerged from the modelling results (Figure Ex.1).

- 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

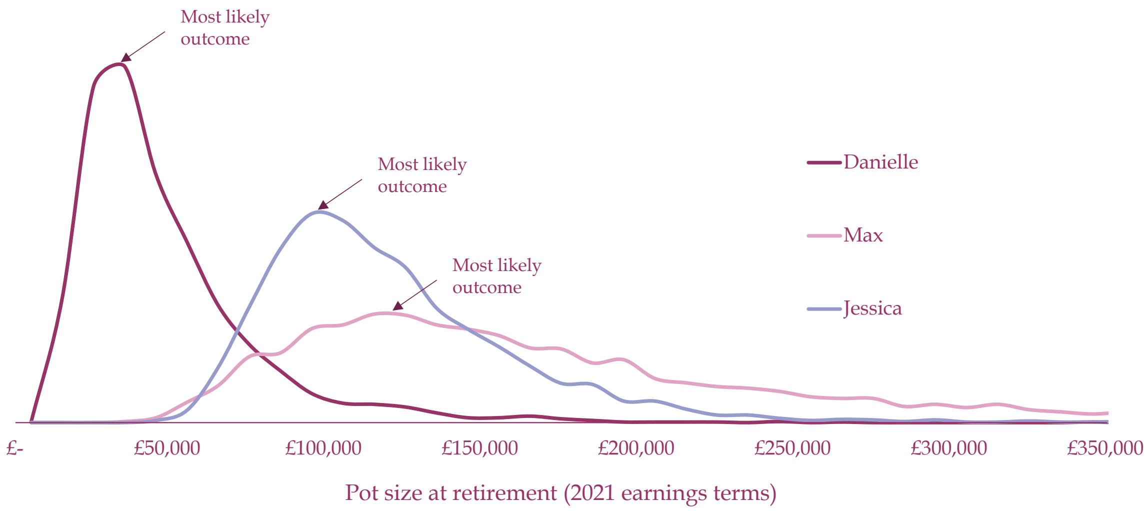
While VFM measures and behaviour can help improve long-term savings outcomes, net returns from saving into DC schemes rely on investment conditions and inflation rates which can fluctuate and are not entirely predictable. If a range of possible investment return and inflation scenarios are taken into 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):

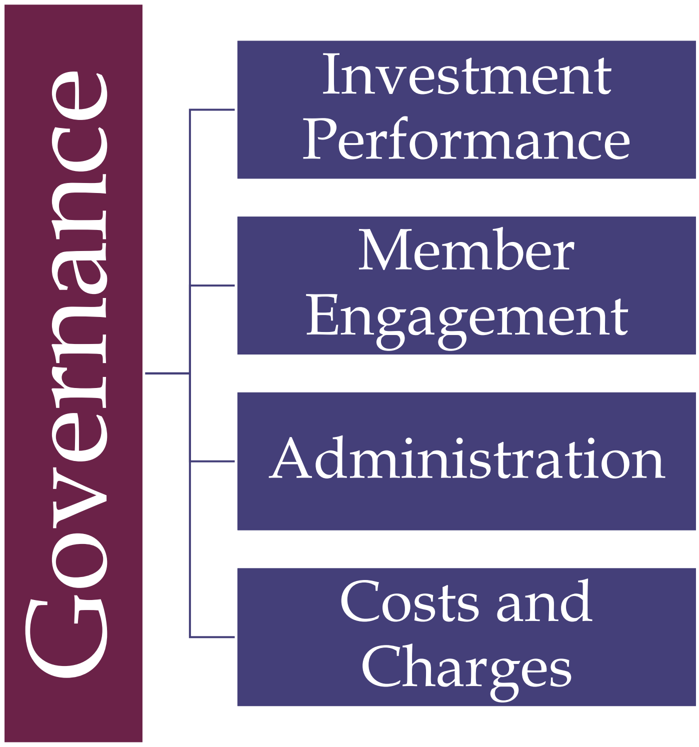
- Investment performance
- Member engagement
- Administration
- Costs and charges

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