PENSIONS POLICY INSTITUTE

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

The Pensions Policy Institute (PPI) held a launch event on 18 November 2021 to launch the PPI report **What can other countries teach the UK about measuring Value for Money in pension schemes?** This report, sponsored by The Pensions Regulator, provides an international perspective to the current UK debate around the definition of Value for Money (VFM) in pensions. It reviews recent developments in five other countries: New Zealand; The Netherlands; Australia; Sweden; The US and considers how these might relate to a UK VFM framework.

The event was run as an online seminar with the key findings presented by lead researcher Nick Hurman (PPI Research Associate) with response from the sponsor Robert Holford (The Pensions Regulator). Around 60 people attended this event, representing a broad range of interests within Government, the investment industry, the pensions industry and the third sector attended the seminar. Emma Douglas (Aviva) chaired the event.

Presentation of key findings and responses

Emma Douglas welcomed everyone to the event, she thanked The Pensions Regulator for sponsoring the research and introduced the research report. She then introduced Nick Hurman (PPI) to share the findings of the report.

Nick Hurman, Research Associate PPI, presented the key findings of the research. He thanked the sponsor and set out the scope of the research, presenting a roadmap of his presentation.

He started by discussing the reasons for the current attention on value for money in Defined Contribution pension schemes in the UK as context for the international comparisons. VFM is very important following automatic enrolment increasing the number of savers.

He then went on to introduce the international comparisons, comprising the lessons learned from five other countries: New Zealand, the Netherlands, Australia, Sweden, and the USA.

New Zealand: The importance of clarity of objectives

The Government is under pressure to improve value of default providers accused of achieving low returns with high charges. This led to default providers moving from a conservative portfolio to a more balanced portfolio to target long-term growth. Re-tendering process for default providers assessed value for money looking at both quality of provision, (including features such as consumer engagement, information and advice), and subsequently looking at fees charged. This process allowed the government to select default providers in a clear rational manner with low fees while establishing consistent standards.

He explained that the regulator set out value for money principles required to be applied by fund providers. The principles separate inputs and expected outcomes rather than putting the two together so guidance focuses on evaluation of the schemes' actions and then six measures to assess these.

Nick then explained how the office of the retirement commissioner drives consumer engagement by providing a suite of tools and calculators to assist consumers in managing their finances. He illustrated this engagement by presenting figures that suggest a third of participants contributes at higher than minimum levels.

Netherlands: costs of economies of scale are limiting to smaller schemes

Nick went on to describe the role of scale in value for money in the Netherlands. There is an argument for consolidation based on the economies of scale and associated cost reductions. Data from the Netherlands suggests that economies of scale on investment costs have shrunk to nearly negligible levels while there are still economies of scale on administration costs. However, Nick pointed out that remaining modest cost economies in The Netherlands are largely exhausted once fund size reaches around £500 million. He explained this as a result of 3/4 of small funds having been consolidated since 1992 and also that higher investment costs arise for larger funds as they invest in complex and costly assets.

However, Nick pointed out that the scale of Dutch profession is much greater than the current UK DC, so the UK has more opportunities for cost savings and smaller schemes via economies of scale through consolidation.

Australia deploying regulatory benchmarking to drive Value for Money

Nick reported on analysis in Australia by this Australian Productivity Commission which was critical of Super funds efficiency and competitiveness pointing out high levels of fees and a wide range of returns. In particular the underperformance of for-profit funds relative to not-for-profit funds.

To combat poor performance, the Australian government introduced measures to "call out" badly performing funds based on benchmarking of net investment outcomes. Funds that fail a five-year performance test relative to the benchmark must write to members advising them of this and referring them to the YourSuper comparison tool to enable members to review their products performance against others in the market. Performance test in two consecutive years are prohibited from accepting new members. Nick reported on findings from the Australian productivity Commission that compared an investment a benchmark invested in listed assets versus one invested in unlisted assets Found but the unlisted asset portfolio provided a 0.8% annualised additional return or 17 years suggesting that the impact of investing in unquoted assets is relatively modest and may struggle to overcome the additional cost drags.

Sweden: challenges of using choice to drive Value for Money

Nick then went on to explain the Swedish premium pension system which was created in the 1990s to make higher returns possible in the basic State Pension by investing a small proportion of public pension savings into a DC scheme invested in capital markets. There was a default option created at the outset, however the Swedish government encouraged investors to choose their own portfolios. This message was presented by the government to the public via pronouncements and a well-funded advertising campaign. This campaign led to two thirds of savers choosing to create their own portfolio at launch, overcoming the usual powerful effect of designating a default. However, the government reduced advertising spending, leading to fewer and fewer new participants making an active investment choice. Less than 1% of new participants in 2016 chose their own portfolio, and many of those invested in the marketplace did not subsequently manage their portfolios actively.

United States of America: using the market to drive Value for Money

Nick explained the key feature of the DC system in the United States is leakage of funds from the DC system resulting from members withdrawing on a triggering event or employers forcing out low balances when changing job. This is a key Value for Money issue.

Nick went on to discuss the most common USA workplace DC arrangement, the 401(k) plan. A substantial number of 401(k) plans are invested in equity funds and the investment fees for equity funds reduced substantially from 0.77% in 2000 to 0.39% in 2010. However, this is significantly related to the size of the scheme with smaller schemes having a 0.79% fee for his schemes with over $1 billion may charge half this amount at around 0.34%.

He described how index funds have grown in popularity in the United States increasing from 17% of 401(k) assets in 2006 to over a third of assets in 2017. Index funds are passive, so they charge substantially lower fees than active funds. The average asset weighted fees of all passive funds was 0.12% in 2020 compared with 0.62% for active funds. The growth in index funds has been largely driven by the adoption of target date funds. However, target date funds are controversial, critics claim that many fiduciaries responsible for selecting their plans of target date funds don't understand how these funds work, and lawsuits challenging target date fund selection or reporting is on the rise. The US Senate has asked the

Government Accountability Office to review the use of target date funds in DC retirement plans. Nick also commented on the general rise of lawsuits challenging schemes on their fees as being excessive and not representing Value for Money.

Nick also described the difficulty of measuring Value for Money in the USD market, as it is difficult to obtain consistent publicly available data on the schemes forcing analysts to rely on 3rd party data.

Nick concluded his presentation by summarising the different elements of each country's approach to Value for Money. He then handed back to the Chair.

Emma then handed over to **Robert Holford, Head of Strategy, The Pensions Regulator** to respond to the findings.

Robert thanked Nick and PPI for the report. He discussed the Joint discussion paper that The Pensions Regulator and the Financial Conduct Authority are producing, looking to establish a holistic framework for assessing Value for Money in UK pension schemes.

He commented that as a result of Automatic Enrolment there are more savers than ever, and that those savers are relying on the industry and regulators to make sure that pensions are looking after their money correctly, so that when they come to retire they feel confident and empowered to make the right decisions. He went on to say that data transparency is an essential starting point to achieve that and to be seen to achieve that. This needs clear and comparable standards that are agreed upon, to aid decision making for the members themselves and enable the industry and regulators to ensure products meet the needs of the members.

He noted that we are operating with an inertia-based system where most of the savers are in default investment funds so that is where we need to concentrate. The system must have defaults that deliver to the interests of the individual with nudges in the right direction.

Robert then illustrated some points with examples from the international case studies. Saying that the New Zealand system shows the importance of the regulator taking the lead in driving Value for Money, that the Dutch experience of driving Value for Money improvements through consolidation contains a warning on the limitations of scale effects on reducing costs, Sweden shows how engagement can work for better outcomes, but sounded caution that to rely on engagement requires ongoing investment in engagement, the USA shows the challenges of relying on a purely private market approach to value for money assessment.

Robert concluded by emphasising the importance of a member outcome focused to approach regulation, and that Value for Money is a key priority area to achieving this shift. He then handed back to the Chair.

Emma introduced a pre-recorded video message from **Dr Allison O'Connell, PPI Governor** presenting the view from New Zealand.

Allison discussed the way that New Zealand has formulated its approach to value-for-money. She spoke of the work done to achieve a consensus, as a result of three things: clarity of purpose, complementary roles, and the simplicity of KiwiSaver as a product.

In terms of clarity of purpose, she discussed the review of default funds that occurs every seven years, and that it was signalled well in advance that Value for Money was going to be a focus of the review. Government ministers indicated to officials that they wanted certain Value for Money measures to be achieved around engagement and value for those with low balances.

She outlined the second part, the roles of the public bodies involved and how they are complementary to each other. The bodies involved are the regulator (the Financial Markets Authority), the government policy department (the Ministry for Business Innovation and Employment) and the Office for the Retirement Commissioner. Allison spoke of how these organisations meet regularly, know each other's role within the system which complement each other well. She spoke of how New Zealand is an outward looking country in policy areas, they look to see what other countries are doing and that this approach aids in reaching consensus.

She spoke of the simplicity of KiwiSaver, how it is a well known and understood product in New Zealand. She noted that even though there are many providers and they may each do things a little differently the general structure is very simple and that the pot-follows-member approach aids in that, and in the introduction of Value for Money principles.

Allison then handed back to the Chair.

Discussion

Emma then introduced the additional panel for the question and answer session of the event. The panel included the speakers, Nick and Robert, along with Darren Philp of Smart Pension, Nike Trost of the FCA and David John of the AARP Public Policy Institute and invites each to give a brief response to the findings.

Emma then opened up the floor for questions. Topics discussed in the Q&A session included amongst others:

- Improving outcomes for the millions of people, can we hope that a concentration on Value for Money will help? It was discussed whether VfM will encourage people or the government to increase the contributions and thereby improve outcomes.
- Whether we can learn from the Australian net-benefit system for statements to present understandable information on benefit statements. It was noted that these are useful in Australia where products are rather standardised but may be less easy to compare in the UK. There was also discussion of the consequences in Australia in the form of interventions.
- There was discussion on the transparency of performance of default funds. It was noted that there may be difficulty for end users to understand but that is not a reason to ignore. Especially for funds with trustees who have fiduciary duty to act for members.
- There was discussion on what members can actually do if there is a poor Value for Money assessment. It was noted that the employer chooses the scheme and pays a contribution, if the member chooses to leave and go with a different scheme there is no requirement on the employer to contribute to any other scheme.

Closing Remarks

Emma Douglas then invited the panellists to make closing remarks. Following these remarks, Emma thanked the attendees and closed the event.