PENSIONS POLICY INSTITUTE
PPI

Review of the Default Fund Charge Cap and Standardised Cost Disclosure – Response from the Pensions Policy Institute

1. Response

1.1 This is the Pensions Policy Institute's submission to DWP's call for evidence for the review of the default fund charge cap and standardised cost disclosure.

1.2 The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

1.3 This submission does not address all of the specific questions in the consultation, neither does it seek to make policy recommendations. Rather, the response points to the research that the PPI has conducted into charges over the past two years.

1.4 There are four detailed research reports that provide evidence relevant to the review. These are;

a) Charges, returns and transparency in DC - what can we learn from other countries? Published in 2018

b) Pension charging structures and beyond; an outcomes-focused analysis. Published in 2019

c) Policy options for tackling the growing number of deferred members with small pots. Published in July 2020

d) Financial sustainability of master trust pension schemes. Due to be published in August 2020

2. Key points

2.1 The UK currently has low charging levels compared to other countries. However, these countries have different experiences of introducing DC schemes.

2.2 The UK currently has little transparency on the ways in which costs and charges are calculated.

2.3 Charges need to be considered alongside contribution levels, investment strategies, member communications and experience, the strength of governance oversight and the impact of having multiple pots.

2.4 A low charge does not guarantee good value. People approaching retirement with multiple pension pots are more likely to lose out compared to people who either have a single pot throughout their working lives or who consolidate their pension whenever they change employer.

2.5 Policies aimed at consolidating pots are likely to provide a better long-term solution than tackling charging structures. Altering charging structures is unlikely to resolve the problems associated with the growing number of small, deferred member pots.

2.6 Policies designed to increase consolidation involve trade-offs and some present potential market difficulties. Some policy models, such as a lifetime provider model, would involve significant restructuring of the regulatory framework governing pension schemes.

2.7 Charging structures have an impact upon individual members, but also affect the financial sustainability of the scheme more broadly, so careful consideration must be given to ensure that charges are appropriate for expenditure needs.

2.8 DC master trusts are a relatively recent development and have high start-up costs particularly as most pots will remain small. Thought must be given to the balance between charge levels and structure and the impact on the viability of the scheme.

3. Charges, returns and transparency in DC - what can we learn from other countries?

3.1 The full report can be accessed here.

3.2 The research compared charges in the UK with those in the US, the Netherlands, Denmark, Sweden and Australia.

3.3 It found that UK charges are typically lower than other countries when expressed in Annual Management Charge (AMC) terms. However, the differences in the ways in which pension schemes are structured and levels of and liabilities for administration costs mean that this comparison does not reveal the full picture.

3.4 Economies of scale in Australia and the US have led to significant decreases in charges, with the move to passive investment strategies a further contributing factor. Analysis of these trends could assist assessment as to how quickly charges might be expected to move in a growing DC market, such as the UK. This might help inform decisions about changing the UK charge cap. A reduction from 0.75% AMC to 0.50% AMC, for example, would represent a 33% reduction, equivalent to over 15 years' worth of scale and efficiency change, based on the Australian and US experience.

3.5 Unlike in some of the countries examined, the UK has no current requirement to break down the charges made between investment and administration. It may be important for all stakeholders in the UK market to have access to this data and to facilitate attribution analysis to manage outcomes better as scale grows in UK DC.

3.6 Fee transparency initiatives can be successful when industry works closely with regulators. It will be important to monitor the impact of fee disclosure in the UK asset market as trustees and IGCs gather and analyse the data now becoming available under the Institution Disclosure Working Group initiative (IDWG) disclosure template.

3.7 Transaction costs data disclosure is emerging for all countries studied in the report with the exception of the US. These costs are not levied directly but are charged within the fund being reflected in the reduced value of the assets. However, there is little analysis of transaction costs data so far. This may accelerate with the introduction of new voluntary investment fund disclosure sponsored by the Financial Conduct Authority (FCA).

4. Pension charging structures and beyond; an outcomes-focused analysis.

4.1 The full report can be accessed here.

4.2 The main finding from the research is that charging structures and levels impact on member outcomes in retirement, but they are not necessarily the most important factor. Charges need to be considered alongside contribution levels, investment strategies, member communications and experience, the strength of governance oversight and the impact of having multiple pots.

4.3 Our research showed that a low charge does not guarantee good value. People approaching retirement with multiple pension pots are more likely to lose out compared to people who either have a single pot throughout their working lives or who consolidate their pension whenever they change employer. The amount they lose will depend on the nature of the charges they face across their different pension schemes.

4.4 Charges do not necessarily reflect costs. The costs incurred in running a pension scheme are many and complex, and not all fall within the remit of the cap. Key among those that are exempt are transaction costs, which may be volatile and can be difficult to predict. This means that the composition and nature of charges is not always obvious, creating a transparency deficit.

4.5 Transparency is important, but not necessarily a solution. Greater transparency in terms of default strategies and their costs and charges will allow for greater understanding of the charges levied by providers but may not always produce data that members or employers can understand or use effectively.

4.6 Different charging structures will result in different outcomes for savers. Combination charges (where an AMC is combined with either a flat fee or a contribution fee) generally provide better outcomes over time than an AMC-only approach. This is particularly true when an individual has deferred or multiple pots, where the same AMC continues to be levied even when contributions have ceased.

4.7 PPI modelling shows that some form of pot consolidation could help savers to secure better retirement outcomes if they have multiple pension pots, but that moving between different charging structures does not necessarily mean they will be better off.

5. Policy options for tackling the growing number of deferred members with small pots.

5.1 The full report can be accessed here

5.2 The report explores the potential outcomes on the number of deferred pension pots, charges for members and costs for providers of a range of policy options.

5.3 Policies aimed at consolidating pots are likely to provide a better long-term solution than tackling charging structures. Altering charging structures is unlikely to resolve the problems associated with small, deferred member pots, as charges either erode member pots or prevent schemes from breaking even on pot management, and deferred pots will not generally grow large enough to overcome these issues (unless they are re-joined by the member or transferred to consolidate with other pots). If DC pension pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation is required. With all policies, there are trade-offs to consider.

5.4 Influenced by a round table with key industry stakeholders, the report considers the potential impact on small pots of the following policy options which were preferred by the participants:

- Dashboards: platforms that allow members to view all pots with different providers in one place and could facilitate more consolidation.
- Same provider consolidation: returning members are re-enrolled into their deferred pot.
- Pot follows member: pots move with members to new employer's schemes.
- Member exchange: a form of pot follows member, which allows for the reassignment between schemes of all existing pots into the current active scheme.
- Lifetime provider: members remain with the same provider throughout their working life.
- Default consolidator: pots deferred for a year, transfer to a consolidator provider, with members being given an opportunity to opt out.

5.5 All policies have potential benefits and drawbacks, a combination of policies may be helpful going forward. All of the policies explored reduce the number of deferred pots, the charges that members pay, and the costs paid by providers, to some degree. However, the policies cannot be judged solely on their economic impact. All policies involve trade-offs and some present potential market difficulties such as giving schemes a competitive advantage or encouraging "cherry picking" of members who appear most profitable. Some policy models, such as the lifetime provider model, would involve significant restructuring of the regulatory framework governing pension schemes.

5.6 The trade-offs for employers, members and providers involved in each policy will need to be considered by policymakers. While the lifetime provider and pot follows member policies reduce the number of deferred pots, member charges and provider costs most significantly, these have potential market drawbacks attached such as significant systemic change (lifetime provider) or placing an increased burden on provider and employer administration (pot follows member). Therefore, other policies with less significant drawbacks or a combination of policies are worth considering.

Policy	Trade-offs	
	Potential positives	Potential negatives
Dashboards	• Encourages engagement	• Potential for lower levels of consolidation
Same provider consolidation	• Simplicity • Reduces administrative burden on providers and employers	• Less comprehensive coverage • Potential for "cherry picking"
Pot follows member	• More comprehensive coverage • Reduces administrative burden on employers	• Increased pot erosion resulting from transfers to schemes with higher fees • Increased administrative burden for providers • Potential for "cherry picking"
Member exchange	• A simpler version of pot follows member	• Less comprehensive coverage than pot follows member • Delay in transfers leading to pot erosion • Potential for "cherry picking"
Lifetime provider	• Policy simplicity • Ease of administration • Most comprehensive coverage	• Unfair competitive advantage • Significant systemic change • Increased administrative burden for employers • Potential for "cherry picking" • Delay, leading to small pot generation
Default consolidator	• More comprehensive coverage • Provides for those who change jobs frequently or move in and out of work • Low administrative burden on employers	• Unfair competitive advantage • Delay in transfers leading to pot erosion • Potential for "cherry picking"

6. Financial sustainability of master trust pension schemes.

6.1 This report will be published on 27th August 2020. An embargoed version is attached separately.

6.2 The report examines the factors impacting on the ongoing financial sustainability in the DC master trust market and the potential future challenges that they might face.

6.3 Charging structures have an impact upon individual members, but also affect the financial sustainability of the scheme more broadly, so careful consideration must be given to ensure that this is appropriate for expenditure needs.

6.4 DC master trusts are a relatively recent development and will have high start-up costs particularly as most pots will remain small. Thought must be given to the balance between charge levels and structure and the impact on the viability of the scheme.

6.5 The master trust industry is unlikely to achieve breakeven on costs until around 2025. Thereafter, the industry may generate annual profits which will accelerate as the funds under management grow. However, in reality there may be some reduction in the profits as providers seek to achieve a competitive advantage by reducing their charges, while still having a large enough pool of assets under management to achieve a profit from the charges.

6.6 There are a number of known future challenges which are likely to impact master trust costs moving forward.

- Pensions dashboards: Data cleansing exercises necessary for the implementation of pensions dashboards are likely to present additional costs for master trusts, both on an immediate and ongoing basis.
- Deferred members: Small pots belonging to deferred members are likely to become an increasingly important issue as job mobility continues to grow. While active pots are more continuously administered as new contributions are regularly received and allocated, deferred pots present their own administration issues as a result of inefficiencies in administering multiple pots for the same person or maintaining contact with an individual without having a current employer to provide contact information.
- COVID-19: While the full impact of COVID-19 on pensions is not yet certain, reductions in overall contribution levels as a result of increased unemployment and volatility in the stock market are likely to impact master trusts' income from charges, at least in the short-term.