Summary
- There are concerns the focus on cost has been at the expense of a broader understanding of other factors, which can cause detrimental effects upon pension funds, such as limiting investments to simple passive options, scaling back administration offerings, decreasing contributions or reducing governance.
- There are no common parameters or a basic framework of what 'good value' means.
- It is recommended that each element of the scheme's performance be measured and plotted to determine where it is doing a good job and on what to focus resources.

Squeezing every drop

DC schemes have seen much focus on costs lately, but how can schemes ensure that they are truly getting value for money, asks Pádraig Floyd

Value for money has, quite rightly, become a central plank of the industry-wide project to make defined contribution (DC) fit for purpose in the 21st century.

The reasons for reform are varied, from pragmatic business succession planning – employees won't be able to afford to retire, the problem faced by many employers in the US – to ultra-extreme levels of pro-consumer activism, where all charges are bad and the industry is simply ripping people off.

The truth, as usual, lies somewhere in between, but where is hard to say as value for money has been somewhat hard to define.

Good value or good outcomes

The debate focused initially on 'good member outcomes', which many saw as industry shorthand for 'won't get sued/ won't anger the regulator'.

But it quickly became focused on costs, with the government weighing in with an absolute charge of 75 basis points (bps). It is now looking at broadening the scope and introducing restrictions on the charges for post-retirement products and possibly even reducing the existing charge cap further to 50bps.

Many feel the focus on cost has been at the expense of a broader understanding of other factors, which can cause detrimental effects upon pension funds.

"In small schemes, there will always have to be sacrifices, while in larger schemes, economies of scale allow more of these boxes to be ticked, while still being able to work well inside the charge cap," says Muse Advisory director Ian McQuade.

"Only if the fiduciaries of these schemes – be they trustees or investment governance committees (IGCs), consider all aspects of the service will they be able to identify whether they are providing a value for money service."

National Association of Pension Funds (NAPF) interim head of investment affairs Ian Cowell says product providers are moving in the right direction, but can't force change down trustees'/ IGCs' throats.

"People choose the flavours they prefer and if they don't get it, you can try and try and educate them or create a good default," he says. "Ultimately, it may converge on what costs the sponsor the least."

Keep it simple, stupid

But J.P. Morgan Asset Management client advisor, UK DC, Annabel Duncan says the best thing to do is keep it simple and think of it in terms of income replacement.

"What is a good outcome for one member may not be good for another," she says. "Whereas asking how much of their salary a member would like to retain into retirement is a far better question."

That's certainly a start, but what's lacking are common parameters or a basic framework, says Newton head of DC Catherine Doyle.

"The trouble is, it's a bit philosophical and adds complexity depending on whether you run a trust or contract-based scheme, as the definition may vary," says Doyle.

This requires a cost/benefit analysis of all elements of the scheme, as trying to fix investments alone will simply fail.

Cutting corners

McQuade agrees, and scale will provide better value for members, as "the charge cap is bound to mean that corners have to be cut", he says.

"Whether that means that the scheme is limited to very simple passive investment options, a substandard administration offering, or the governance of the scheme is severely limited, there will be an impact somewhere."

The proliferation of small DC schemes means very few members receive the best value for money solution available and the argument that it doesn't matter in a trust environment as the employer will pick up the bill doesn't wash, adds McQuade.

"Most companies have a limited budget and if they are spending their budget on the administration and governance, they cannot also spend it on higher contributions. And we all know that higher contributions is the biggest determinant of better outcomes."

While contributions are important to allow the compounding of returns, the investment element has already been reined in at many schemes and this may have a long-term detrimental impact, undoing much work in recent years to control volatility and build better defaults.

"Many feel the focus on cost has been at the expense of a broader understanding of other factors, which can cause detrimental effects upon pension funds"

"We know from our studies that there will be a squeeze on diversification and the contribution of active management," says J.P. Morgan Asset management head of UK DC Simon Chinnery. "This will lead to an unintentional concentration of risk and a greater exposure to events, market risk and, arguably, to volatility."

Of course, the returns may work in your favour, but they may not and the level of diversification at the end of a member's glidepath may be reduced as a result.

"Good diversification comes at a price", says Chinnery, "and while you have to cut your cloth accordingly in this market, it's better to have more than one source of return, as many companies have not got a great track record of delivering returns."

Yet, there is broad consensus (with few dissenting voices) that the focus on cost alone will drive down quality and ultimately affect value for money.

If lower costs are not to necessarily mean lower quality, the focus needs

to shift, says Doyle, from costs to net returns and their consistency, which will provide a much more balanced assessment about achieving the desired outcome, however that is defined.

"In the context of DC, it has to be about steady investment returns preserving capital and minimising the downside," adds Doyle. "The cost debate in this context is simply unhelpful."

Reaching equilibrium

A balanced approach – in fact scorecard – is exactly what LCP partner Andrew Cheseldine would recommend to schemes. Each element of the scheme's performance can be measured and plotted to determine where it is doing a good job and what it will focus resources on.

Not only does this provide excellent data on the performance of the scheme – which contributes to the value for money debate, but it can allow the scheme to negotiate a better deal for the members.

Cheseldine offers a recent example of a scheme that had beaten all its benchmarks, with one exception – plan design – which is not really a trustee role, but the employer's.

"One trustee client took this to an employer and said it was within its power to improve the scheme through changing its design, introducing save more tomorrow or salary sacrifice," he says.

"The employer agreed the scheme had done a good job, and saw how they could sell the idea of salary sacrifice to the employee and now it is investing the national insurance saving as additional contributions," says Cheseldine.

"Most companies have a limited budget and if they are spending their budget on the administration and governance, they cannot also spend it on higher contributions"

In whom we trust

The biggest obstacle to resolution of this matter remains the regulatory landscape.

Whether you consider the triumvirate of Department for Work & Pensions (DWP), The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) a troika or Cerberus, it is not something the industry is able to manage or control.

Many in the institutional arena find the dual regulatory aspect of TPR and FCA as problematic, but whichever way you cut it, the FCA's role is to protect consumers and members are consumers from a policy perspective, says Vanguard Asset Management defined contribution proposition manager Steven Charlton.

"What would be useful would be for the regulator to share examples of schemes that offer good value for money," says Charlton. "Not necessarily name them, but it would be helpful to demonstrate how good value could be achieved."

The regulator will only regulate if it feels the market hasn't made a decent job of reform, but if good value becomes a quantified regulatory metric, it will cost money and become a drag on performance, fears Charlton, and thereby undermine the very thing it was seeking to achieve.

The whole world in your hands…

While he would welcome a hiatus from political or regulatory intervention for a period so the industry can assess the impact of recent changes, including freedom and choice, Cheseldine says there should be no need to look to the regulator for a plan.

He believes that by applying the DC code of practice and having good governance in place, most of the other things will fall into place. And the motivation for schemes and employers alike should be strong, he adds.

"If you spend most of your employee benefit budget on pensions – and most clients do – you might as well ensure your members are getting value for money."

Written by Pádraig Floyd, a freelance journalist