Value for money (VFM) in pensions has come under increased scrutiny over the past 12 months, with the government and regulators looking to address issues in this area. Jack Gray analyses the potential drivers and barriers to improving pension value for savers

Summary

- The Financial Conduct Authority (FCA) published a consultation on driving value for money (VFM) in pensions in the summer of 2020 after finding concerns with the way some Independent Governance Committees (IGC) operate.
- The government and regulators have been taking steps on improving VFM in pensions, such as through consolidation.
- However, there are issues that need to be resolved to help drive better VFM, including the proliferating small pots problem.
- Concerns have been raised that too much focus on reducing costs will impact VFM and member outcomes.

Getting your money's worth

VFM in pensions has been creeping up the priority list as more people begin saving into DC schemes. This has led to changing regulation that will require DC pension trustees of schemes with less than £100 million of assets to assess whether their scheme offers VFM and, if not, to either wind up and consolidate, or make improvements.

In the summer of 2020 the FCA launched a consultation on a clearer framework for value assessments and a requirement for IGCs to compare their company's schemes against others in the market.

Around the same time, the government published a call for evidence on how effective pension costs, charges and transparency measures are at protecting member outcomes and providing VFM. These consultations, alongside an increased drive towards consolidation and the recent government decision to scrap flat fees on auto-enrolment pension pots worth £100 or less, shows the appetite for change is growing.

However, industry figures warn that a narrow focus on costs and charges is detrimental to achieving better VFM, alongside a lack of measurement and comparison, and the growing number of small deferred pension pots.

Achieving VFM

"For DC schemes, VFM is often driven by scheme size and that is why we've seen engagement in DC master trusts continue to increase in recent years and expect that to increase into the future," explains Willis Towers Watson head of OneDB, Gareth Strange.

"There is already significant regulation for DC master trusts and the level of that regulation has seen the number of master trusts in the market reduce from 90 to 37, partly due to the requirement for authorisation. We believe this will see greater VFM for members in DC schemes."

PLSA head of DC, master trusts and lifetime saving, Alyshia Harrington-Clarke, adds that scale is a "significant driver" of VFM, as the more people participate in workplace DC schemes and minimum automatic enrolment contributions increase, it is expected that the growth in assets will generate cost savings.

"Schemes with more funds under management can negotiate better terms and lower fees," Harrington-Clarke adds. "Very large funds can also more efficiently access asset classes that are more difficult for smaller schemes to participate in such as private and real assets."

Harrington-Clarke notes that although scale helps in providing VFM, smaller schemes can still offer VFM in comparison to larger schemes if they are run efficiently.

Additionally, she highlights that although the charge cap is an "important saver protection", average charges are closer to 0.45 per cent due to trustees acting in the best interests of their members and "healthy competition" in the market.

LGIM head of DC, Emma Douglas, adds: "Value isn't just about charges and can be improved by better and more engaging communications, enhanced investment performance and scheme governance, smoother administration and access to a wider range of benefit options."

"Consolidation can sometimes lead to better VFM for members but not always," explains Hymans Robertson head of governance consulting, Laura Andrikopoulos. "A simplistic approach does not recognise the reality that not all schemes will be offered the same pricing when consolidating to larger overall arrangements and that valuable benefits in hybrid schemes can be lost."

Strange notes that VFM is "a more opaque concept" in DB schemes, but points to analysis by the Society of Pension Professionals that suggests members in poorly-run DB schemes could be 15 per cent worse off than those in well-run DB schemes.

"It is therefore important that DB trustees also consider whether the decisions which they make provide members with the best outcomes," he adds.

Barriers to improvement

For further progress to be made, Harrington-Clarke explains that a balance of regulation needs to be found. She warns that a passive approach risks causing harm to savers and could damage consumer confidence. "But for a healthy, functioning market it is important that compliance costs don't become so prohibitive that they lead to higher saver costs or act as a barrier to innovation or new market entrants," she says.

"DC schemes have historically had little to no exposure to private markets, and compliance with the charge cap has, at least in part, contributed to this constraint.

"The charge cap alongside the public discourse on costs and charges, and as yet no consistent way to measure and compare VFM, has encouraged trustees to focus on reducing costs rather than seeking performance."

Douglas states that while costs are an important measure, "VFM is more than just costs and we believe more attention should be given to risk-adjusted returns and member outcomes".

"The more expensive asset classes, which may bring more diversification and better returns, might not be included in the default strategies due to the focus on costs as the main driver of VFM," she continues. "This focus tends to lead to simpler solutions with less attention paid to investment strategy. A poor investment strategy may result in a significantly worse member outcome."

Andrikopoulos adds that trustees' VFM assessments tend to focus on what members pay for and do not require any consideration of sponsor contributions.

She states: "Regulations and guidance need to encompass a more holistic definition of value such that member outcomes are at the heart of the matter; this would also entail greater focus on contribution adequacy, which is a key driver of value for members.

"Investment performance is a vital part of the equation. Fund managers and asset classes that consistently outperform are worth paying more for."

Another barrier identified is the increasing number of small, deferred pension pots. "Already we have more deferred members than active members, and the research that Now Pensions sponsored at Pensions Policy Institute last summer predicted that by 2035 we will see 27 million small, deferred pots," says Now Pensions director of policy, Adrian Boulding. "The effect of the Covid-led recession could now easily double that number."

"These small pots all cost money to administer. It doesn't matter whether the charges are explicit or hidden, a world in which multiple small pension pots are legion will depress VFM for everyone."

Playing the long game

Andrikopoulos believes that there is a lack of focus on member outcomes within regulations and guidance that ask governing bodies to consider VFM, "meaning those bodies are not necessarily asking the right questions, ie what truly improves member outcomes and therefore contributes to greater value".

"VFM is subjective," states Tisa head of retirement, Renny Biggins. "What one individual deems an important aspect of VFM will not necessarily feature in another individual's list of priorities.

"We acknowledge that the list needs to be finite and practically allow for an VFM assessment to take place by scheme trustees, which should include costs, net investment performance, administration, and quality of communications."

Sustainability may need to be considered for long-term member outcomes. Schemes are still able to pursue an ESG-friendly strategy while providing VFM, says Willis Towers Watson head of sustainable investment, Adam Gillett.

"We believe that sustainable investment is central to long-term successful investor outcomes, and therefore schemes should be pursuing strategies that integrate ESG and apply effective stewardship as a core part of what they do.

"It's certainly the case that many strategies currently over-claim, over-sell and over-price their sustainability credentials, and it is therefore important that schemes are clear in their expectations and understanding of the strategies they implement, and view ESG as an integral part of that."

Written by Jack Gray