Institute and Faculty of Actuaries

30 October 2020

DWP - Improving outcomes for members of defined contribution pension schemes

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Government's consultation. Members of the Finance and Investment Board and Pensions Board have contributed to our response. We have limited our response to questions on which our members have relevant knowledge and expertise.

Question 1: We would welcome your views on the reporting of net returns - how many past years of net returns figures should be taken into consideration and reported on to give an effective indication of past fund performance?

We accept that net returns are the best available measure of investment performance, but there are practical challenges to ensure that they give an accurate and fair indication of past performance. We would also make the wider point that past performance is not necessarily a reliable indication of future performance or future scheme quality. In our view, therefore, it is important that past fund performance is not given undue weight when assessing schemes for potential consolidation. In that context, the length of performance history should be long enough to indicate a long term return and ideally this would be a relatively consistent period from one assessment to the next, as well as being consistent with the periods used for the comparable schemes.

Trustees and the Regulator may also need to take account of lifestyling strategies and their take-up, since arguably a higher return on a fund that does not match the targeted benefit may not generally indicate better value for members in future. This is just one reason why the comparison of net returns needs to be presented carefully, and why the communication of the value for members assessment needs to be suitably caveated to ensure members reading the Chair's Statement are not encouraged to take inappropriate individual transfer or investment decisions. The IFoA is, to some extent, less concerned with the past period covered, and more concerned with how trustees and the Regulator might use past returns to judge overall future scheme quality, as well as how they might be expected to apply relative weightings to their assessment of returns and the quality of the scheme's governance.

Schemes have very many different charging bases, and it will be challenging to take account of these in a consistent way when reporting net returns. One example is a scheme with a combined charging basis of fixed fees and a percentage management charge. The proposals may push such a scheme to reporting only against investment costs (not administration).

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A second example is a Master Trust with different charging bases for different employers. It may be driven to report with reference to its cheapest scheme rather than full costs. At the most aggregated level, it is very difficult to obtain information about members or governance, so this would be difficult for the Regulator to detect.

Question 2: Do you think that the amending regulations achieve the policy aims of encouraging smaller schemes to consolidate into larger schemes when they do not present good value for members?

In our response to DWP's 2019 consultation 'Investment innovation and future consolidation', the IFoA took a cautious view about the need for nudges to encourage consolidation. Our response also noted that: "we would expect there to remain an option to explain why consolidation is not deemed appropriate, rather than permitting TPR to force consolidation".

The current proposals would require schemes to consolidate unless there are 'exceptional circumstances'. These are defined in terms of one or more of three circumstances: "where trustees are realistically confident that required improvements can be made, and/or where the wind up and exit costs may exceed the costs of making such improvements, and/or where there are valuable guarantees that would be lost on consolidation". We accept that these three scenarios cover most circumstances where a scheme might argue against consolidation. However, there is clearly scope for disagreement if the Regulator believes trustees' improvement plans are not 'realistic' but the trustees feel 'confident' about them.

We would also welcome greater clarity on the position for schemes where there are guarantees which might be lost. It is likely to be particularly difficult for trustees to determine an appropriate approach in cases where, for example, some members have guarantees and others do not. Some members might therefore benefit from consolidation, but it would be to the detriment of other members. In such situations, we might expect the Regulator to take a firm approach to ensuring necessary improvements are made.

The current proposals put additional responsibilities on trustees, however it is usually the employer who will be expected to meet the costs of either improving or consolidating the scheme. We would welcome guidance on the approach trustees should take where an employer is either unable or unwilling to meet these costs.

In our response to the 2019 consultation we also suggested that consolidation should be defined widely to include investment trust structures or securitisation, as this would minimise administrative disruption and cost. We are not aware of any reference to this approach in the current consultation and would welcome clarification on this.

Question 3: Do you believe that the statutory guidance increases clarity about the minimum expectations on assessing and reporting on value for members for specified schemes? Are there any areas where further clarity might be required?

In the IFoA's view, any value-for-money assessment must consider performance in the wider context of scheme governance. It would be useful to indicate the Regulator's expectations of trustees who find their scheme has achieved slightly weaker returns than a comparable larger scheme, whilst having strong governance. The draft regulations require a comparison, but an exact comparison may not be realistic, e.g. if the trustees have a higher or lower risk appetite than those of the larger scheme. It is not clear whether the trustees must then conclude the scheme provides poor value for members, or whether they could reasonably conclude it provides good value.

The draft regulations are also potentially not clear that the £100m asset threshold and the three years of operation should apply to DC assets only (which we assume should be the case in relation to a hybrid scheme).

We are also surprised that this consultation is looking at schemes with up to £100m of assets, given the previously proposed threshold was £10m. As we understand the concern about poor governance is primarily in relation to much smaller schemes, the higher threshold will largely lead to trustees of larger schemes (up to £100m) having to assess value for members based purely on past performance. Arguably there is no reason for a cut-off at £100m, other than DWP's separate desire to encourage investment in illiquids for medium sized schemes, and we are not convinced that the higher threshold is appropriate.

Question 4: Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?

We have no comment. Legal commentators may be in a position to respond.

Question 5: What should we consider to ensure a multi-year approach to calculating performance fees works in practice?

We are not in a position to comment as performance fees are not currently used in DC.

Question 8: To what extent will providing a multi-year smoothing option give DC trustees more confidence to invest in less liquid assets such as venture capital?

We welcome the idea of developing a multi-year smoothing option as a way of giving trustees greater flexibility. However, we do not expect multi-year smoothing to have a significant effect on allocations to illiquid assets. We suggest that the perception that performance fees are not value for money has more impact on investment decisions than how fees are charged over time. In any case performance fees are often not used - for example the consultation paper notes (paragraph 49) that most investment trusts have annual management charges.

Question 9: Do the draft regulations achieve the policy intent? Do you have any comment on the definitions used?

We support DWP's intent to formalise the exclusion from the charge cap of costs of holding physical assets such as property and infrastructure – including maintenance costs, business rates, insurance and management fees among others. We are aware that in practice this could be complex: we understand for example that it would entail having a look through into REITs management costs, increasing their attribution for the charge cap, while holdings through other vehicles would be reduced.

In addition, the example used is a UK definition of REITs which is not recognised internationally. This essentially creates an annual legal / compliance bill for schemes, rather than clarity. We would encourage the government to identify which of the main international REITs and IT definitions should be considered for look-through.

Question 11: We propose that where the default arrangement includes a promise, the trustees of the scheme should be required to produce a default SIP. We propose that this should be produced within 3 months of the end of the first scheme year to end after the coming into force date. (a) Do you agree with this policy? (b) Do you agree that the legislation achieves the policy?

We are not lawyers, but suggest it needs to be checked that the amendments to implement this proposal do not result in the inclusion of DB schemes.

Question 12: We are proposing that, for relevant schemes, charges and transaction costs should be disclosed for any fund which members are (or were) able to select and in which assets relating to members are invested during the scheme year. (a) Do you agree with this policy? (b) Do you agree that the legislation achieves the policy?

We would welcome such disclosure which would improve clarity on charges and costs

Question 13: Do you agree with this proposed change? Do you have any other comments on this topic?

We agree that this change is necessary as the position is currently not clear and this should resolve the issue.

If you would like to discuss any of the points raised please contact Matthew Levine, Policy Manager (Matthew.levine@actuaries.org.uk) in the first instance.

Yours Sincerely,

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