Mind the Cap
DC innovation under the microscope

Defined Contribution
Investment Forum

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Introduction

Auto-enrolment has introduced a whole new population of savers into workplace pension schemes. The policy has been a great success thus far, with over six million people auto-enrolled at last count. Regulators have instigated certain safeguards with the objective of ensuring that savers, who may not always be engaged with pensions, get the best possible outcomes from the system nonetheless.

The government introduced a charge cap in April 2015. It restricts the costs members pay for default funds (including administration, investment fees, communication costs and payment of fees to providers of professional services) to an annual limit of 0.75%.

The cap has divided opinion within the pensions industry, with some investment managers arguing that the added costs of active management are justified because this style of investment offering will ultimately deliver better outcomes. Regardless of ideological stance, over the last year, pension funds and the industry alike are adapting to the charge cap and seeking the best possible investment solutions within a cost constrained environment.

The DC Investment Forum decided to gather a panel comprising trustees, consultants, and asset management firms to discuss their perspectives on the charge cap, how the industry is adjusting to the new reality, and what challenges remain.

On 3rd February 2016, the panel met to discuss six key topics.

In relation to the charge cap, the panel discussed whether member outcomes were being compromised by too heavy a focus on costs.

The problem of low contribution rates was discussed, and the panel considered various means of trying to increase member engagement.

In relation to the introduction of auto-enrolment, two broad topics were considered; namely whether the lack of scale within the industry arising through many smaller firms setting up pension funds created a two-tier landscape, with engaged and disengaged employers, and whether pension funds are able to enjoy the scale necessary to negotiate favourable terms with suppliers and deliver optimal outcomes for members.

Finally, the panel moved onto considering the 'post-retirement' landscape: how the nature of drawdown will evolve following the pension freedoms, and the possible introduction of a post-retirement charge cap.

Participants

PAUL BLACK, PARTNER, LCP
Paul is Head of LCP's DC investment team. Paul joined LCP in 2005 as a partner in the investment department. He qualified as a Fellow of the Institute and Faculty of Actuaries in 1994.

SHERIDAN BOWERS, EXECUTIVE DIRECTOR – HEAD OF UK & IRELAND BUSINESS
Sheridan Bowers is Head of Vontobel Asset Management in the United Kingdom and Ireland, with responsibility for institutional client relations and consultant relations activities.

STEPHEN BUDGE, PRINCIPAL, DC & FINANCIAL WELLNESS, MERCER
Stephen is a Principal in Mercer's UK DC & Financial Wellness Team. His role is to help companies and trustees to design innovative pension arrangements that provide members with exceptional value for money and in doing so, engage, motivate and improve outcomes for members.

INDERPREET DHINGRA BSC, MBA, PHD(CANTAB)
Inder is a Non-Executive Director, independent pension trustee and an experienced senior executive from the financial services industry. He serves as director of Law Debenture, representing them on the trustee boards of a number of large pension schemes including as chair of investment committees and as Chair of Independent Governance Committee (IGC)

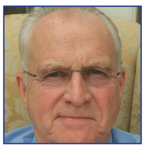
LYDIA FEARN, HEAD OF DC AND FINANCIAL WELL-BEING, REDINGTON
Lydia Fearn recently joined Redington to fill the newly created role of Head of DC and Financial Well-being. Prior to Barclays, Lydia worked at Lane Clark & Peacock and Aon Hewitt, where she specialised in investment strategy and advice.

ROBERT HOLFORD, RETIREMENT LEAD AND HEAD OF STRATEGIC CONSULTING, SPENCE JOHNSON
Robert has eight years' experience in the asset management and consultancy industry. He currently leads the delivery of Spence Johnson's Retirement Practice's market intelligence and consultancy services focused on the DC and Retirement Income markets. His clients include a range of financial industry participants including asset managers, pension's providers and insurance firms.

MARK PEMBERTHY, DIRECTOR, JLT EMPLOYEE BENEFITS
Mark is Head of DC Consulting at JLT Employee Benefits. He has been involved in developing workplace DC pension propositions since 2006, spanning the introduction of pension simplification, auto-enrolment, DC quality standards, freedom & choice and workplace savings solutions.

DARREN PHILP, DIRECTOR OF POLICY AND MARKET ENGAGEMENT, B&CE
Darren is the Director of Policy and Market Engagement and his responsibilities include policy, public affairs, press and marketing communications. Previously he held directorships at the NAPF: Director of Policy and Director of the Pension Quality Mark. Prior to joining B&CE, Darren joined the NAPF from HM Treasury, where he worked for almost 13 years in a variety of policy and economics-related roles. Darren headed up the Treasury's Pensions and Pensioners team between July 2007 and October 2010.

RENÉ POISSON
René retired after a 30 year career with JP Morgan in September 2012. He is an Independent Director of the Universities Superannuation Scheme (USS) and Chair of the Remuneration Committee, Chair of the JP Morgan UK Pension Plan, Chair of the Standard Life Independent Governance Committee, Director of the Standard Life Master Trust and, Chair of the Advisory Committee of Five Arrows Credit Solutions.



NICK WHEELER
Nick has many years of experience in the pensions field, concentrating in the main on the management and administration of schemes. He has held a number of senior roles. During his career Nick has been actively involved in professional trusteeship and has been Chairman of the Trustees for the Volvo Group UK Pension Schemes since 1997. Nick is a regular speaker at seminars and conferences and the author of articles in the pensions technical press

Key Findings

- Although auto-enrolment has successfully managed to increase the membership of DC pension schemes, contribution rates remain very low. Innovation in the way that schemes communicate with their membership, to make it simpler and more 'outcome' focused, was seen by the panel as being a key development.

- The difficulty around gauging what constitutes a good member outcome has meant that the debate around how to measure 'value for money' has been heavily focused on cost. Panellists agreed that 'cheaper isn't always better', especially in terms of investment offerings.

- Blending active and passive products was seen as a way that some of the benefits of active management, such enhanced performance or better managed volatility, could be achieved within the charge cap.

- A consequence of auto-enrolment is that a very large number of small employers are opening pension schemes to comply with the regulation. This was seen as problematic because it is creating a two-tier system of engaged and disengaged employers, distinguished by their level of commitment to delivering high quality outcomes for members.

Key Findings

- A secondary issue with the rapid growth in the number of sub-scale pension funds is that they are unable to negotiate favourable terms with providers in the same way that large funds are. Consolidation was seen by the panel as an important way in which smaller pension schemes could achieve this scale, and deliver better member outcomes.

- Before the pension freedoms, people were forced to annuitise their pots on retirement, and this gave them the security of a guaranteed income for life. Now members move from an institutional environment where they are under the guidance of schemes, to a retail environment with higher associated costs. Panellists discussed whether greater regulation would be needed in the 'post-retirement' phase, and considered that the introduction of a post-retirement charge cap is inevitable.

- With the options available to members following the pension freedoms, the panellists observed that many members with small pots were taking their pensions out as cash. They also noted that drawdown was working well for wealthier members, yet innovation to design a mass-market drawdown solution has been slow.

Uncertainties in the current DC investment landscape

The regulator has stated that delivering 'value for money' should be the primary objective of DC pension schemes. In itself, the very notion of 'value for money' is difficult to define, as it is dependent on a fine balance between achieving the best possible outcomes for members and the costs that members will be paying for that outcome.

The panel agreed that the greatest uncertainty currently lay on how to define what constitutes a 'good member outcome'. As Darren Philp, director of policy and market engagement at mastertrust The People's Pension put it: "What we mean by 'a good member outcome is currently very difficult to define. With the recent budget changes that introduced the new pension freedoms, the whole concept of people securing a guaranteed income has gone away. The regulator has done a lot of good work trying to define member outcomes in terms of inputs, but now more than ever the debate needs to focus on the outcomes that members are trying to achieve".

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Lydia Fearn, head of DC and financial well-being at consultancy Redington suggested some practical ways of putting members first. "When we talk to clients, we talk about 'beginning with the end in mind'. So as a DC scheme what is your end goal, what do you want members to achieve, what is a reasonable outcome from a scheme perspective? When I was at Barclays we talked about a Living Pension, so that was a level of about £17,500 including state pension. It might seem low in the context of London but this is a UK figure, but it gives you a benchmark to start from. We're very keen … to help members understand where they are on this journey, because they might put 1% in and think that's enough. We need to help and say 'It's not enough, we need to aim for a total contribution (including employer contributions and tax relief) of around 12 to 15%.'"

Members of the panel went on to consider whether the introduction of the charge cap has compromised members' access, through their schemes, to higher quality investment products.

Mark Pemberthy, director at JLT Employee Benefits, said this is particularly an issue for those members in bundled schemes, "where the charge cap isn't just an investment cost cap but also includes the costs of administering the scheme. In this instance the scheme's investment budget might only be 10 or 15 basis points and the only way to incorporate the benefits of more diversified range of assets within the scheme is by blending these investments with passives."

The idea of 'blending' active and passive products was supported by Sheridan Bowers, head of UK and Ireland at Vontobel Asset Management, who was concerned that without this, members would lose out on the benefits of active management. "The focus on cost has led many people to look at passive management, and with markets as they've been that hasn't delivered fantastic returns for members. There are benefits of active management within DC schemes, and if you want to bring that within the charge cap then you can combine a good tried and tested unconstrained active manager with a passive manager."

Taking a different stance, Inder Dhingra, an independent trustee at Law Debenture, argued that active management could be better used on managing volatility, rather than using it primarily for generating growth. "If members get returns earlier in life they will have a good outcome, but if they get low returns early on they're going to have a bad outcome for the same schedule of payments going into the system. Volatility managed products can therefore play a central role in reducing the disparity of the performance that members experience."

Looking towards the future, panellists discussed proposals that transaction costs were to be incorporated within the charge cap. Stephen Budge, principal, UK DC and financial wellness at Mercer UK, argued that "it's absolutely critical that we get a clear understanding of what the costs are. The focus should not be how much the portfolio has turned over, but rather how much this turnover has cost the individual."

René Poisson, chairman of the J.P. Morgan UK Pension Plan, supported this view by arguing that a simple focus on costs could "lead to sub-optimal decision making by individuals who simply receive the message that 'all costs are bad'. If the investment strategy is producing the returns to justify those costs, then they can actually be seen as good."

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Level of contributions

Member outcomes are largely determined by contributions, and current contribution rates are too low, the panel agreed.

Paul Black, partner and head of DC investment at consultancy LCP described low contributions as being a key impediment, stating: "as an investment adviser I can devise a great investment strategy and have a manager implement it at a low cost, but with minimal contributions you're not going to get a great member outcome".

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The panel considered a variety of potential solutions on how to improve engagement. One suggestion put forward was to improve the tools used by schemes to communicate with their members.

As summarised by Nick Wheeler, chairman of trustees at the Volvo Group UK Pension Schemes, "Where we've got to be innovative is in the member communications targeted at trying to get members to step up their contribution levels. Even though we know targeting 10% contributions is likely to be too low in the long run, we are still well short of achieving even this modest target in many schemes at the moment". Inder Dhingra took this one step further, stating that in the future, schemes should focus on developing communication mediums that were both "outcome focused and instantaneous".The panel also stressed the importance of education as a means of promoting engagement. As summarised by Sheridan

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Bowers, "education is important, from a very early stage. If you understand something you're more likely to engage with it. If you're engaged and you know what it's going to give you you're more likely to put in a better level of contribution at the beginning and then that can build up through time".

Taking a slightly different approach, Lydia Fearn, head of DC and financial well-being at consultancy Redington suggested that contribution rates could be improved by pursuing behavioural techniques such as 'Save More Tomorrow'. These campaigns work by linking escalations in contribution rates to members' pay increases.

> *"We have to bring all aspects of financial planning together to help people meet their short, medium and long-term savings goals".* ***Lydia Fearn***

"As a corporate, you can time escalations in contributions to ensure people don't feel like they're losing money because the increase not funded from existing pay but by giving up some of their pay rise," said Fearn. Fearn also suggested that the idea of saving for a pension was outdated, that the messaging should be recalibrated, with members being encouraged to take a more holistic approach to their finances: "It's not just about pensions, people don't think like that, we have to bring all aspects of financial planning together to help people meet their short, medium and long-term savings goals".

> *"Whatever the size scheme, they all deserve the same level of advice and the same level of investment services as anyone else."* ***Lydia Fearn***

The panel also discussed the idea of introducing compulsory contribution rates, but agreed that in the current political climate it is unrealistic to expect this solution to be enacted. Nonetheless the panel agreed that despite the successful introduction of auto-enrolment, further innovation was needed to ensure the long-term success of the policy.

As one panellist put it, "Compulsory contributions is a horrible political bullet for any politician with a five-year plan to bite, but the reality is that although auto enrolment is a great idea, it is to some extent also a fraud because it is not on its own going to get anyone to the level of pension savings they ultimately need to get to."

A two-tier pension system?

A consequence of auto-enrolment is that it has led to a rapid growth in the number of very small DC schemes. Their small size limits their access to the benefits enjoyed by larger schemes capable of using their scale to negotiate better terms from their suppliers.

> *"DC definitely needs scale"* ***Mark Pemberthy***

For Lydia Fearn this was a key issue: "small schemes don't get the quality and the service that they deserve. Whatever the size scheme, they all deserve the same level of advice and the same level of investment services as anyone else."
René Poisson supported this view, stating "If you don't have £1billion you're not going to get real efficiencies in your dealings with investment managers and others", while Inder Dhingra pointed out that "Larger scale schemes can help to influence what managers get onto platforms, an influence that small schemes unfortunately do not possess."

For Darren Philp, the huge number of sub-scale pension funds is a key concern that should be addressed through consolidation. "What worries me is the mass market. Consolidation is both inevitable and necessary."

This was supported by Mark Pemberthy, who expects significant consolidation in the short-term. "DC definitely needs scale. It doesn't need homogeneity, you want to keep a strong degree of choice and flexibility, but we're at 80 master trusts plus probably 20 or 30 insurance companies that are active in one way or another, and that is clearly way too many."

Nevertheless, the panel recognised that a lack of scale does not necessarily prevent small schemes from delivering good member outcomes. As Paul Black explained, "We deal with some relatively small DC schemes where the governance is by far above some of the larger schemes we deal with. These small schemes haven't necessarily got the best investment fees but the company is often paying for a wide range of other things which is adding to the members' experience and potentially contributing to a good outcome."

Furthermore, with the introduction of the charge cap, smaller schemes are generally benefitting from lower fees, as investment suppliers compete for DC assets. Mark Pemberthy observed: "We've seen some funds reduce their charges quite significantly, leading to the question of whether there were excessive charges in the first place or whether this move is simply a volume play on the fund managers part in order to help them achieve a meaningful presence in the DC marketplace."

Retirement pension freedoms and the future of drawdown

Whilst not subject to the charge cap, the panel discussed the uncertainties associated with drawdown. The pension freedoms effectively removed the need for members of DC schemes to annuitise their pots, meaning that members can either take their pensions either as cash from age 55, enter a drawdown arrangement, or opt for an annuity.

Although this has created substantial uncertainty, the panel discussed how the changes have opened the door for innovation in the products offered to members at the point of retirement. The panel expressed its concern that the pace of change may not be keeping up with the rapidly evolving demand.

"There is innovation happening in terms of deferred annuities and products that take you into retirement, but we are not seeing enough of it at the moment." ***Inder Dhingra***

As Inder Dhingra put it, "People don't know when they're going to retire, they don't know what they're going to do in terms of their options. Are they going to take cash or drawdown, or even stay invested and not have income for a long time and then have drawdown later on in life or even a deferred annuity? There is innovation happening in terms of deferred annuities and products that take you into retirement, but we are not seeing enough of it at the moment."

"the industry has yet to focus on the fact that the new freedoms are fundamentally changing the timeframe of retirement" ***René Poisson***

This was supported by René Poisson who felt that "the industry has yet to focus on the fact that the new freedoms are fundamentally changing the timeframe of retirement, which in turn is changing the nature of the investment solutions that are needed. It also changes the nature of lifestyling because retirees are no longer heading for a defined endpoint."

One reason for a lack of new products coming to market in this space was highlighted by Paul Black, who stressed the need for innovation amongst platforms in developing the systems capability to distribute these new products. "There are suppliers thinking, 'Here's a great investment product which works in that environment' and the providers are thinking, 'How can we reconstruct our systems and deal with all these people we want to take in?'. In the main, however, there is very little marrying together of these two conversations."

The panel went on to discuss which players are most likely to be the drivers of such innovation. Sheridan Bowers argued that "most asset managers are probably not best placed to produce a complete solution for a client as doing so can involve considerable financial planning. Product design could potentially be better housed with consultants, or through the platforms themselves combining different strategies into a solution. This would leave managers free to focus on their core strengths which will lead to better outcomes for members".

Others such as Mark Pemberthy generally agreed, claiming that "insurers are at an advantage because they have the opportunity to use their balance sheet where they can offer longer term guarantees to retirees than is possible through straightforward investment solutions".

"The DWP and the Treasury are sometimes pulling in different directions, and there's a lot of short-term thinking driving the current pensions policy agenda."
Darren Philp

Darren Philp argued that in itself, the new regulation will have a new positive effect on spurring innovation so long as it offered long-term stability. However, he voiced concerns that although 'the freedom and choice agenda allows the industry to innovate massively and brings pensions into the modern world of retirement, what is most likely to kill this innovation is persistently high levels of regulatory change. The DWP and the Treasury are sometimes pulling in different directions, and there's a lot of short-term thinking driving the current pensions policy agenda."

Engaged vs. disengaged employers

The panel discussed the danger that the rapid growth in the number of pension funds established by small employers as a consequence of auto-enrolment could lead to the emergence of a 'two tier' pension system characterised by 'engaged' vs 'disengaged' sponsors.

> *"We're about to auto-enrol 1.8 million small employers that don't want anything to do with pensions."* ***Darren Philp***

For many small employers, pension provision is seen as an administrative and financial burden, the result of which is that many employers are simply meeting the minimum standards required under the auto-enrolment legislation and not trying to optimise member outcomes.

Darren Philp described the magnitude of the potential problem. "We're about to auto-enrol 1.8 million small employers that don't want anything to do with pensions. You have the large employers that engage fantastically well but there's 60-70% of the pension population not employed by these employers that just won't have access to that opportunity."

This is in stark contrast to larger schemes, such as the Volvo pension scheme represented by Nick Wheeler, where "expenses other than the investment expenses are paid by the employer", meaning that schemes are able to offer members the best possible investment offerings within the charge cap.

> *"Personalisation is a must, and pro-active engagement is essential"* ***Stephen Budge***

Mark Pemberthy expanded on this to suggest that rather than being a two-tier market, there are three segments of the market which can be distinguished by the level of sponsor engagement. "I'd argue that there's a three-tier market. You have unbundled schemes with fantastic support from the employer, you have a mainstream bundled marketplace, and then you've got a pure auto enrolment market, with master trusts which are looking to deliver not just the bundled services within the charge cap but actually doing a huge amount of administration and communication within that for a massively diverse set of employers".

The panellists debated methods of developing tools which could be used not only to communicate with members more effectively, but also to help the employers to interact with their employees.

Indeed, by developing tools that help sponsors to engage with their membership the panel felt that standards could be raised across the range of pension outcomes. In Stephen Budge's view, "Personalisation is a must, and pro-active engagement is essential. The tools that we are developing at Mercer include a way of sending members personalised videos, so that providers and employers can really engage members through a brief video sent via email or through their phone which talks to them about their own savings, their situation, their expected outcome and then links directly to an action."

The post-retirement market

In the progression from the accumulation phase to retirement, members of DC schemes, who were previously compelled to annuitise their pension, are now faced with a variety of options. Furthermore, they leave a regulated, low cost/charge-capped market with good governance provided by their schemes, and enter a market which characterised by high charges and considerable complexity with a much greater emphasis on the role of personal responsibility.

For Darren Philp, this represented an area of concern, since, "while talking about increasing individuals' decision-making capabilities, levels of personal responsibility, and engagement, is absolutely fantastic, it overlooks the fact that a large swathe of the population will simply not be able to achieve this."

Other members of the panel agreed, and suggested that the post-retirement market should be more heavily regulated, especially when it came to costs, and discussed the introduction of a charge cap in the post-retirement market.

> *" I can see a charge cap going through retirement as well." **Lydia Fearn***

As Lydia Fearn explained, "Members move from an institutional environment to a retail environment, where costs are dramatically different, thinking 'now what do I do?' That whole conundrum needs to be looked at and solved and I can see a charge cap going through retirement as well."
Another significant area of cost for members entering retirement are the transaction costs associated with moving assets from the scheme into another arrangement. Inder Dhingra observed that "Some of the large funds take you up to the end point of retirement and then you can either stay invested or take the whole fund somewhere else. There's a huge amount of transactional cost involved in going in and out of funds, even though retirees in drawdown will end up being invested in very similar sorts of products."

The panel discussed the fact that, while the solution to this problem lies largely with the providers, some schemes are trying to help manage the transition.
Mark Pemberthy summarised this issue by arguing that, "How people access their money is completely dependent on the will, the budget or the systems capability of those providers, and very few are able to offer in-scheme drawdown with no transition of assets and no differential in charges. Commonly, individuals transfer to an individual policy on very different terms to what they've been enjoying in the accumulation phase."

Pemberthy continued: "We are seeing trustees wanting to make sure that, even if they're not providing drawdown within the scheme, as part of a natural progression they have a preferred provider for decumulation so there is negotiated charges and streamlined communication, administration and investment transition when members reach retirement."

Overall the panel concluded that there was still considerable room for innovation in the pre- to post-retirement transition and that this was an issue that was likely to be a key focus for the industry over the next few years.

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The Defined Contribution Investment Forum would like to thank Spence Johnson for chairing the roundtable and authoring the report. Schroders kindly hosted the event and we would like to thank them for their support.