Response from the Pensions Policy Institute
17/10/24

Pensions Policy Institute

The FCA Value for Money Framework Consultation

1. Response

1.1 This is the Pensions Policy Institute's (PPI) submission to the FCA's Value for Money Framework Consultation.

1.2 The 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 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 summarises relevant conclusions and analysis from research that the PPI has conducted in recent years:

- 2024: **Pension scheme assets – how they are invested and how and why they change over time** https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2024/pension-scheme-assets-how-they-are-invested-and-how-and-why-they-change-over-time/
- 2024: **What could effective pensions engagement look like?** https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2024/2024-02-15-what-could-effective-pensions-engagement-look-like/
- 2023: **What role could alternative assets play in DC investment strategies in the future?** https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2023/2023-03-09-what-role-could-alternative-assets-play-in-dc-investment-strategies-in-the-future/
- 2022: **How will future pensioners use guaranteed income products?** https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2022/2022-09-08-how-will-future-pensioners-use-guaranteed-income-products/
- 2022: **Could DC pension default investment strategies better meet the needs of members?** https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2022/2022-02-02-could-dc-pension-default-investment-strategies-better-meet-the-needs-of-members/
- 2021: **What is the impact on member outcomes of different non-capped charging structures?** https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2021/2021-11-24-what-is-the-impact-on-member-outcomes-of-different-non-capped-charging-structures/
- 2021: **What can other countries teach the UK about measuring Value for Money in pension schemes?**

https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2021/2021-11-18-what-can-other-countries-teach-the-uk-about-measuring-value-for-money-in-pension-schemes/

This covering letter sets out the main conclusions of these research reports as they relate to Value for Money. Please read the reports for the underlying analysis. This response covers many of the same research reports highlighted in PPI's response to the 2023 Value for Money Consultation, updated to include more recent research from 2023 and 2024.

1.4 We are happy to talk further about any of the research discussed in this response if it would be helpful for the consultation.

2. Relevant conclusions from: "Pension scheme assets - how they are invested and how and why they change over time"

2.1 There has been considerable consolidation within the DC market, with the number of master trusts reducing and many employers moving from single-employer trusts to master trusts. Since 2012, the number of non-micro trusts has fallen by two-thirds from 3,660 to 1,220 in 2022.[1] The average size of trust-based schemes has risen from £6m to £117m over the same period. The average size of a master trust stood at £2.9bn at the end of 2022 and £8.8bn at the end of 2023, with the five largest reporting assets of £113bn.[2]

2.2 As DC arrangements grow in size, so their approach to investment becomes more sophisticated. The very largest master trust, Nest, with £36bn of AUM at the end of 2023[3], has moved away from 100% pooled funds to a position where a significant proportion of their assets are managed on a segregated basis, giving them scope to invest in a broader range of asset classes. As more master trusts reach critical mass, asset classes may broaden out still further with more adopting a segregated approach. Consolidation in DC is expected to support and drive greater diversification of asset classes; with this may come some additional costs for members and increased demands on governance bodies to ensure that new asset classes are understood. Continuing to put member outcomes at the forefront of decisions will be essential.

2.3 DC schemes are increasingly exploring private markets and alternatives but some barriers remain. DC scheme asset allocation has been shaped in part by the limits on charges, the

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[1] TPR (2023) DC trust: scheme return data 2022 to 2023

[2] Go Pensions (2024) DC Master trust league table 2024

[3] Nest (2024) Investment approach

relatively small scale of many schemes and the dominance of pooled funds rather than direct investments. However, even before the Mansion House Compact, many DC schemes had begun to expand their exposure to private markets through private equity, venture capital, private credit, real estate and infrastructure investments, driven by the need for diversification in the portfolio and recognition that illiquid assets can yield higher returns (the illiquidity premium). A lack of positive correlation between public and private market performance and lower levels of volatility are also attractive features.

Historically, private markets have delivered good returns for investors. PPI has estimated that the illiquidity premia for private markets ranges from 1% to 7% over what could have been earned from other comparable liquid assets over the long term. However, some commentators, including the Bank of England[4], have expressed concerns about the sustainability of returns. The Financial Times (FT)[5] has reported concerns about the sustainability of private equity returns due to the maturity of the sector and higher borrowing costs.

2.4 The growth in private market assets will largely be driven by the very small number of open DB schemes in the public and private sectors and DC funds. However, the policy initiatives currently underway could lead to some unintended consequences:

- The potential for a herding effect with providers all putting more money into private equity at the same time, which could have a detrimental effect on asset prices and returns.
- A risk that disclosing asset allocation could lead to less innovation in asset allocation as schemes tend towards the mean.
- Disclosure could lead to a reduction in UK investment if it becomes more evident that schemes that are overweight in the UK are underperforming.
- Any attempt to force providers to invest more heavily in certain asset classes is a direct challenge to trustees' fiduciary duty and can be expected to be met with considerable backlash. The Government could also find itself in conflict with regulators, both of whom put member outcomes at the forefront of their strategies and policy.
- Changes such as the lifetime provider and the small pots initiative could disrupt the current trend towards consolidation and, with funds moving more between providers, could lead to providers needing to emphasise liquidity.

2.5 Members of DC schemes with a default fund should see better designed defaults, more diverse portfolios, better risk management and better returns as asset allocation becomes more sophisticated. However, charges may rise with the higher costs associated with some asset classes. This may be offset by the economies of scale and negotiating power of fewer, larger

[4] Bank of England (2024) Financial Policy Summary and Record – March 2024

[5] FT (2024) Is private equity actually worth it?

schemes. In addition to seeing their pensions yield better and more secure retirement incomes, DC members could also benefit from the societal improvements that successful investment in UK business should yield – more secure jobs, economic growth, wage growth and better public services.

3. Relevant conclusions from: "What could effective pensions engagement look like?"

3.1 Some people will need greater support to achieve positive retirement outcomes as they will find it more challenging to make informed active choices that are likely to deliver these and are therefore unlikely to achieve positive outcomes through engagement alone. If the shared goal of Government and industry is for everyone to achieve positive retirement outcomes, and better levels of financial wellbeing throughout the whole of life, other mechanisms will be required for those for whom full engagement is unachievable.

People with lower levels of financial capability and knowledge are both less likely to make active choices and less likely to benefit from this behaviour. Among those who do make active choices, they are at greater risk of making decisions that will lead to poor retirement outcomes. Some people with higher levels of financial capability and understanding will also be challenging to engage because of personal characteristics and circumstances and are therefore at risk of failing to take actions that are likely to improve their retirement outcomes. The approach that is appropriate for these groups, be it engagement-focused or other policy levers, differs according to their level of financial capability and their openness to engagement.

3.2 Building a more segmented approach to engagement, in order to better meet the need and preferences of different groups, is likely to be a costly exercise, given the improvements in communications and data required to develop and implement. Considering the current relatively simplistic use of segmentation and personalisation, this will require significant experimentation and refining of approaches to find strategies that are effective for different groups. This is likely to be too large an individual undertaking for even the largest of schemes, underlining the need for a joined-up approach across the industry, in conjunction with Government.

The cost associated with developing strategies aimed at stronger engagement, including more complex segmentation, needs to be weighed up carefully against its potential benefits, particularly in light of increased focus on VFM.

While data-driven approaches to engagement will be costly to develop, they may be more cost-effective to manage on an ongoing basis, as well as potentially better meeting member expectations and needs.

3.3 Building consensus on more nuanced measures of engagement could support the development of realistic targets, more effective tracking of progress and the ability to more accurately assess the balance between cost and benefit. If better outcomes are the goal of engagement, then success should be measured not just on levels of interaction, but on ultimate outcomes for individuals.

4. Relevant conclusions from: "What role could alternative assets play in DC investment strategies in the future?"

4.1 There are low levels of investment in alternative assets by DC schemes - partly because the last decade has focused on the implementation of automatic enrolment and building scale. However, schemes appear increasingly focused on evolving and improving investment strategies, building quality, incorporating sustainability objectives and demonstrating VFM. An increased focus on reporting and transparency is likely to drive further change. The DC market has been shaped by a focus on charges and competition, but the DWP and regulators are working to shift this focus towards overall value for members.

4.2 Charging structures and considerations around cost may act as a barrier, whether real or perceived, to greater investment in alternatives and particularly illiquids. Investing in illiquid assets tends to be more expensive and these investments may take some time to generate returns. Performance fees continue to be a challenge, in terms of price competitivity, inaccessibility for smaller schemes, and potential for unfair sharing among members when there is a time lag on levying the fees.

5. Relevant conclusions from: "How will future pensioners use guaranteed income products?"

5.1 Future pensioners will be more dependent on their DC savings, as they will be less likely to have a DB safety net to fall back on. Decisions about how to access DC savings will more significantly impact retirement experiences and running out of DC savings too early in retirement could cause serious financial difficulties. Pensioners will face increased levels of financial risk, which extend from at-retirement decision making into mid and late retirement, and many will not have the financial capability to make informed decisions without support.

5.2 Both working and retiring has become more flexible. Working lives are becoming increasingly heterogeneous as levels of casual and self-employment increase, and people move in and out of the labour market more frequently. Alongside changes in working patterns, retirement is also changing as people find they need to work longer to provide for themselves and/or prefer a more gradual move into retirement through part-time/flexible working than a cliff edge. This means that income will need to be taken in increasingly flexible ways, to help people both through retirement transitions and into retirement.

5.3 Engagement, communications and guidance for those in the saving phase will need to be designed to help people prepare for their future retirement needs if pension savings are to provide value for members which fits with members' own needs and desires.

6. Relevant conclusions from: "Could DC pension default investment strategies better meet the needs of members?"

6.1 Membership of DC default investment strategies has increased as automatic enrolment has brought more than 10 million people into pension saving, most of whom have remained in their schemes' default investment strategy; 90% of those enrolled in master trust/multi-employer schemes are in the default investment strategy.

6.2 Finding the appropriate balance between two contrasting goals, higher returns and lower risk, is a key challenge when setting the high-level asset allocation strategy of default investment strategies. Since a default investment strategy applies to a wide cross-section of scheme members, it cannot be tailored to each member's individual circumstances and preferences. Rather, the best possible fit must be found to meet a diverse range of needs. This means that, for members who do not fit the typical or representative profile on which the default investment strategy is based, better solutions may exist. In broad terms, those solutions will involve either (a) more focus on the maximisation of return or (b) more focus on the management of risk.

6.3 There are several policy options for ensuring that DC default investment strategies meet the needs of a wider range of members:

- Increasing asset allocation to alternatives could enhance returns while also increasing diversification, potentially benefiting all members.
- Using existing data on members, such as pot size, in order to provide prompts about using non-default (self-select) investment strategies.
- Gathering more data on members in order (a) to make DC default investment strategies more tailored or (b) to provide prompts about non-default (self-select) investment strategies.

7. Relevant conclusions from: "What is the impact on member outcomes of different non-capped charging structures?"

7.1 The average charge in non-qualifying workplace schemes has decreased markedly in recent years, closing the charge gap between qualifying and non-qualifying schemes to 0.05% of AUM.

The closing of the charging gap is assumed to be, at least in part, the result of competitive pressure exerted from schemes subject to the charge cap. Further pressure has been applied from a level of 1% of AUM a year being taken as a benchmark of Value for Money by IGCs where the charge cap does not apply. 14% of assets in legacy schemes still attract charges above 0.75% of AUM.

7.2 Typical charges in a qualifying scheme erode retirement savings by around 14%. Annual charges in these schemes are around two-thirds of the level of the cap. Charges at the level of the cap, which are more indicative of individual personal pensions, erode retirement savings by around 20%.

7.3 Providers of schemes designed to accept transfers in and consolidate schemes have a fundamental advantage over providers targeting the automatic enrolment market. While they are out of scope of the charge cap, they should be able to offer more competitive charges as they do not have to support the costs of small pots through cross-subsidisation. This situation is linked to the issue of small, deferred pots which puts charging pressure on providers who target the automatic enrolment market. Such providers end up managing many uneconomic small inactive pots which will not receive contributions to grow to an economically viable size. This pressure has implications for the members who are paying charges which subsidise the uneconomic small pots.

7.4 Flat fees reduce the need for cross-subsidisation from members with larger pots to those with smaller pots. For schemes which have a larger proportion of small, deferred pots, the removal of flat fees will place additional pressure on the cross-subsidisation of these pots. This balance is exacerbated when pots which provide the cross-subsidisation are transferred out of the scheme.

8. Relevant conclusions from: "What can other countries teach the UK about measuring Value for Money in pension schemes?"

8.1 There are a number of key messages from other countries (New Zealand, The Netherlands, Australia, Sweden and the US) that are relevant to UK DC practice and policy:

- A clear statement of and consensus around the outcomes sought in assessing VFM are a necessary precondition to effecting positive change in which outcomes are expressed from members' viewpoints as things that they value.
- By setting clear, measurable and comparative standards and benchmarks for performance in the key areas of delivery – investment, administration, engagement – it is possible to drive a more effective tendering process for these services to secure VFM.
- Publicly available, consistent, robust and complete comparative data is a vital starting point for authoritative VFM assessments and broader market context. The evidence suggests that this requires a trusted regulatory framework to facilitate.

- There are barriers to members exercising informed choice and so where choice is provided it is unlikely to lead to good outcomes unless the choices available are carefully designed and edited. Close, active governance will be required to manage this process if good outcomes are to be achieved and maintained.
- Achieving scale has positive impacts on costs, but diminishing returns will set in. large funds face new opportunities to achieve diversity in assets through unlisted or direct investments to secure consistent high returns. Evidence suggests that this will increase unit investment costs if these additional returns are to be accessed.
- Consistently positive real investment returns, within appropriate volatility parameters – both upper and lower – are the most significant driver of VFM in terms of net returns. But outcomes for savers in terms of meeting target income levels are most influenced ultimately by the level of contributions.

8.2 Using the international research findings from the report, it could be concluded that a VFM framework should include the following elements:

- Investment performance
- Member engagement
- Administration
- Costs and charges

Overarching these elements is the need for good governance of the system. It is governance that has the power to set, monitor and amend the delivery of the various services to schemes and their members so as to maximise the VFM and consequently the outcomes, in terms of retirement incomes.

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About the Pensions Policy Institute

We have been at the forefront of shaping evidence-based pensions policy for over 20 years.

The PPI, established in 2001, is a not-for-profit educational research Institute. We are devoted to improving retirement outcomes. We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. Each research report combines experience with INDEPENDENCE to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **INDEPENDENCE** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

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