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Introducing a new value for money (VFM) framework for all DC pensions

On 30 January 2023 the DWP, The Pensions Regulator and the Financial Conduct Authority published a joint consultation following the feedback statement last summer, as part of a broader suite of consultations aimed at creating "fairer, more predictable, and better-run pensions".

They propose a "transformative framework of metrics and standards to assess value for money" across all DC pension schemes. The intention is "improve retirement outcomes for millions of defined contribution pension savers".

Background

Our FYI dated 8 June 2022 (DC pensions - how to assess value for money consistently) provides a summary of last summer's feedback statement, which acts as a precursor to this latest consultation. The consultation period for the proposals launched on 30 January 2023 runs until 27 March 2023. The DWP intends to summarise the responses received and then propose next steps.

The DWP, The Pensions Regulator and the Financial Conduct Authority (FCA), have jointly declared that they want to achieve common standards across all DC pension schemes, although they accept that this is "a complex area with mixed views on certain aspects of the framework".

The next step after any consultation responses have been received and reviewed would involve the FCA consulting on specific rules in the FCA Handbook as these relate to providers and Independent Governance Committees (IGCs) of workplace personal pension schemes and the DWP consulting on changes to regulations that apply to trustees and managers of trust-based occupational pension schemes. The consultation does not provide timescales for these or for implementing any changes to the value for money framework.

Challenges in the existing pension market

The consultation starts from the premise that, at present, there are a number of issues with assessing value for money within DC pension schemes. For instance, focusing on cost can dominate decision-making, particularly when the differences are very small. Assessing value is hindered by inconsistent approaches and can be subjective. There is limited transparency around performance and, therefore, difficulties in making comparisons across different DC pension schemes.

Supporting further consolidation

The DWP, The Pensions Regulator and the FCA have determined for some time that consolidation and greater scale has the potential to be in the best interests of savers.

For scheme year ends following 31 December 2021, occupational DC schemes with less than £100million total assets have had to include a comparison of reported costs and charges and fund investment (performance) net returns against three other schemes and a self-assessment of scheme governance and administration criteria. The Government’s expectation was that the trustees of a scheme that fails on these tests should consider winding up the scheme and transferring their members’ rights to another scheme that does offer good value.

Occupational DC schemes with over £100million total assets are currently allowed to continue using previous definitions, guidance and approaches to assessing ‘value for member’ and potentially also wider ‘value for money’.

The current consultation proposes that the new VFM framework will eventually replace all existing regulations on value for members assessments, meaning the introduction of a statutory requirement on all trust-based occupational pension schemes to consolidate if they repeatedly show they are underperforming in the assessment.

Contract-based providers would be subject to similar requirements to improve or consider transferring savers. This would be dependent on the change being “in the best interests of savers”.

What is value for money?

The view of the DWP, The Pensions Regulator and the FCA is that value for money means that DC pension savers’ contributions are well invested in the best interests of savers, and savings are not eroded by high costs and charges in the context of the market today. The concept also includes good customer service and scheme oversight as these “contribute to whether a saver achieves good retirement outcomes”.

They have concluded that the key elements of the VFM framework are:

- Investment performance;
- Costs and charges; and
- Quality of services.

These elements are similar, but not identical, to the three elements already familiar to trustees of occupational DC schemes under £100million.

Investment performance

The proposal is for public disclosure of:

- backward-looking investment performance, net of all costs across a range of time periods and age cohorts; and
- a forward-looking metric for target future performance.

The purpose of these investment performance metrics is to:

- reflect member outcomes;
- enable meaningful comparison;
- support assessment of investment strategies; and
- allow consideration of expected future performance.

The consultation covers reporting periods, granularity and age cohorts. It also proposes the disclosure of two specific risk-adjusted metrics: maximum drawdown and annualised standard deviation of returns.

The approaches being considered for the forward-looking metrics – which may comprise of a single metric for expected return and a single metric for risk – are stochastic modelling or deterministic modelling.

Stochastic modelling involves multiple simulations to project investment performance, with the projected distribution of outcomes being used to estimate risk, while deterministic modelling involves calculating the investment returns with fixed input assumptions and where scenarios are used to illustrate a range of possible outcomes and therefore the associated risk.

The consultation notes a number of challenges for the forward-looking metrics and asks for feedback on the metrics and the approach to be used.

Costs and charges

The consultation proposes that all DC pension schemes disclose total charges for the purposes of comparison with other DC schemes – rather than solely ‘member borne’ charges – as well as disclosing the total amount of administration costs.

The proposed rationale for the former is that including employer subsidies would avoid the situation where schemes where the employer meets some charges would appear to give better value.

The rationale for the latter is that disclosing non-investment costs will enable schemes to better compare the quality of their services against the direct cost of those services.

Quality of services

The consultation proposes that key performance metrics be used to directly assess the value of the services offered by the scheme. Schemes and providers would be expected to report on selected elements of service that are quantifiable. The consultation proposes that “services” covers:

- scheme administration;
- governance; and
- effective member communication to support saver understanding and decision-making.

Scheme administration

The current value for members assessment requirements for trust-based schemes with assets under £100million cover seven key metrics of administration and governance. The proposal is to extend two of these to all DC pension schemes including contract-based schemes.

These are:

- promptness and accuracy of core financial transactions (i.e. payment in and investment of contributions, transfers between schemes, transfers within a scheme and payments out of the scheme); plus
- the quality of record keeping (i.e. the requirement to report data scores for common and scheme specific data would be extended to contract-based schemes).

Governance

The consultation proposes that no standalone governance metric is used, as the overall level of governance would be reflected in other aspects, and it would be challenging to reduce the overall governance to a purely quantitative metric or key indicator.

Member communications

The proposed options for assessing member communications concern the improvement in member outcomes. Schemes would assess and disclose the:

- percentage of members who update or confirm their selected retirement date, how they wish to take benefits, and/or update their expression of wishes; and
- the outcome of member satisfaction surveys, the Net Promotor Score and/or member feedback against a small number of standard focus questions.

Publication of VFM data

A reporting template is being considered and will be consulted on at a later date. There are two options for the publication of the framework data:

- a decentralised approach, where schemes would disclose the data on a publicly accessible website. Trust-based schemes would notify The Pensions Regulator of the URL via the annual scheme return, while contract-based workplace schemes would notify the FCA; or
- a centralised approach where all schemes would submit their data directly via a web portal using a prescribed template, with the data published for a professional audience to use.

The proposal is for framework data to be published by 31 March where the end point for the net returns being disclosed is 30 June of the previous year. Although no implementation dates are proposed within the consultation, this suggests that the 31 March 2024 is the earliest possible date for the first industry-wide VFM year-end, using net-return data as at 30 June 2023.

Trust-based schemes would publish their VFM assessments by the end of October and separately from the chair’s statement. Contract-based schemes would publish their VFM assessment in their IGC chair’s report by the end of October (rather than the end of September which is the current deadline).

Assessing value for money and next steps

The proposed approach is to design multiple benchmarks based on framework metrics or a combination of these. An objective threshold would be set beneath each benchmark that schemes would have to meet or exceed.

An alternative approach would be for trustees and IGCs to compare their scheme with at least three other schemes (with the selection of those schemes to be set by the government, using market comparisons and industry benchmarks). A mandatory step-by-step process for assessing VFM would then apply, focusing on quantitative measures.

At the conclusion of the assessment, schemes would have to state (using a three categories or Red-Amber-Green rating approach) whether the scheme is:

1. Delivering value for money (i.e. Green)
2. Not currently delivering value for money but with identified actions to improve in certain areas that would deliver value for money (i.e. Amber)
3. Not delivering value for money (i.e. Red)

The proposal is that schemes would be mandated to take clear actions following the assessment. For trust-based schemes, The Pensions Regulator could be given powers to enforce consolidation and wind up where the conclusion is ‘Red’, or where it is ‘Amber’ for two successive years.

A phased approach to implementation of a VFM framework

Phase 1

The consultation proposes that the new VFM framework would apply firstly to:

- default arrangements (except where there are very small numbers of savers, or funds below a particular threshold, or where defaults have arisen when savers are moved when further contributions to some investments are suspended);
- legacy schemes (relevant schemes for two or more employees which are not qualifying auto-enrolment schemes and may be closed to new members); and/or
- pension schemes where 80% or more of pension savers were enrolled.

Small Self-Administered Schemes (SSAS) and Executive Pension Plans (EPP) (i.e. micro schemes) will be excluded as these members are usually engaged with, or advised about, investment decisions and would have less need for the VFM framework.

Phase 2

The proposed next phase would cover self-select investment options, non-workplace pensions and DC pensions in decumulation.

The expectation within the consultation is that industry tools would emerge to enable greater market comparability and, following the launch of pensions dashboards, greater engagement from pension savers would also lead to increased interest in the VFM delivered by their scheme.

The future of chair's statements

The DWP is considering the chair's statement that applies to trust-based relevant schemes following the post implementation review published in April 2021.

One option is to split the chair's statement requirements into two separate documents – one that is member-facing and another purely governance document.

Member-facing materials already exist in the form of simplified annual benefit statements plus member websites and apps and so consideration is being given as to whether another member-facing document would be appropriate.

Similarly, from a governance viewpoint, there is consideration around whether a chair's statement would still be necessary when other legislative requirements already fulfil a similar role (e.g. the supervisory return for master trusts and the effective system of governance assessment and own risk assessment for occupational DC schemes).

FCA specific issues

The consultation also covers FCA-regulated workplace pension schemes. It confirms that the intention is to extend the VFM framework across the whole of the DC market in the future, including such schemes, eventually extending to include non-workplace pensions and pensions in decumulation. the consultation raises questions about individual SIPP arrangements where these may be considered workplace pensions.

The consultation also considers whether all IGC chairs should publish a saver-focused summary of the VFM assessment alongside the full IGC chair's report. Finally, the FCA is considering whether workplace pension scheme providers should be directly responsible for preparing and publishing the VFM framework data rather than the IGC and the IGC chair.

Costs and benefits of the proposed VFM framework

The consultation ends with a chapter on the impact of the proposed VFM framework. It acknowledges that there may be additional costs to both providers and trustees as well as the regulators.

However, the government is keen to look at the benefits that it hopes the new VFM framework will provide to savers, by protecting them from potentially poor outcomes and helping drive value for money in the market.

Ultimately, the aim is to help deliver wider benefits such as economic growth from increased investment, economic growth from better investment performance and reduced pensioner poverty.

Comment

This is a further lengthy consultation on value for money and, as the joint foreword from the Secretary of State for the DWP and the Minister for Pensions explains, it acknowledges the large number of people now saving for their retirement within DC pension schemes as a result of automatic enrolment.

They say that this consultation is “a significant step in that journey and is the culmination of joint work” between the DWP, The Pensions Regulator and the FCA that began in 2018. There are also separate forewords from both these regulators.

It is encouraging that these bodies are collaborating towards a consistent approach across all types of workplace DC schemes.

It is clear that these bodies, working together, believe that the benefits of the proposals put forward on 30 January 2023 more than outweigh any previous concerns about policy proposals aimed at a more rapid consolidation of DC pension schemes (the Government had previously consulted on incentivising schemes with assets of between £100million to £5billion to consolidate, but had noted that most respondents ‘reacted unfavourably’ to this proposal).

The consultation also represents a shift in focus towards the member. By proposing that all DC pension schemes use a common effective date and reporting template, coupled with proposals for DC schemes to publish their findings in a more member-friendly document, it will be much easier for members to compare the overall value for money of their own DC pension scheme with the wider market. A similar approach in Australia has appeared to contribute to higher levels of member engagement with their pensions.

Respondents have until 27 March 2023 to provide replies to the 30 questions, which include a request for respondents to quantify costs and share estimates if they are able to do so.

As mentioned, further consultations will follow from both the DWP and the FCA, at which point we would expect timescales for the implementation of the new VFM framework to become clearer.

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