DC Governance Watch

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VFM Assessment & Reporting Investment Returns

Welcome to the first PASA DC Governance Watch focusing on Value for Money. Future editions will focus on different subjects with the aim of delivering views, insight and practical solutions to topics, as considered by our army of experts. The topics will be DC Governance focused but we'll be invite our colleagues from other working groups to contribute their expertise where required. We hope you find this useful and look forward to receiving feedback and suggestions for future issues.

From 5 October 2021, Value For Money (VFM) requirements were introduced for relevant occupational pension schemes with under £100 million of assets, requiring increased reporting and assessments. This edition of Governance Watch addresses some of the issues faced by trustees.

DWP's statutory guidance, completing the annual VFM assessment and Reporting of Net Investment Returns, published in June 2021, states there are three areas to consider and report on:

1. Costs and Charges
2. Net Investment Returns
3. Governance & Administration

1. Costs & Charges

Of the three requirements, this is arguably the easiest section to complete. As trustees, you need to compare the existing scheme fees and charges with three comparators. The comparators must be either occupational pension schemes with assets over £100 million or personal pension schemes. You need to have had discussions with at least one of the comparators with a view to them accepting your scheme, and it's likely one would be a master trust. Comparing the existing scheme charges to the comparators is the next step and the DWP guidance provides a suggested format for reporting these charges in para 56 of the guidance. DWP recommends this process is carried out for self-select funds as well as the default. In many schemes this is straightforward, but the following needs to be considered:

A. If there's a flat administration charge applied to each saver this results in a disproportionate cost to savers with smaller fund sizes, and schemes might need to adjust the cap to avoid breaching the charge cap

This can be addressed by segmenting the membership by fund size to identify the costs and charges for different cohorts (or at least using the median pot size if only one is used based on para 44 of the guidance)

B. If the charges vary by age in relation to the lifestyling changes

The issue has been addressed in the DWP guidance and schemes can report across different age groups. DWP suggested this is at 10-year intervals

C. If the default fund (or one of the self-select funds) is a With Profits fund

With Profits funds don't report on the costs and charges of the fund and obtaining this information has been challenging. If one of the key funds is With Profits, you can't do a comparison if the data isn't available.

D. Who pays the charges?

Where the employer pays some or all the charges, it could improve the value to savvers, there's also the possibility the allocation rates are enhanced to reflect the employer bearing some costs. This should be considered when assessing the fees and charges but can make the analysis more challenging and time consuming to collate

The default should carry a greater weight than self-select funds, but when choosing the comparator schemes, it's useful to choose those schemes which provide a similar choice of funds or a fair comparison will be difficult. When comparing the default, it's recommended the scheme's default is compared with the default of the comparator schemes, even if the investment profile is different. In the case of self-select funds, schemes should compare against the 'nearest comparable' funds of the comparator schemes. Where self-select funds may not have any comparable funds in the comparator schemes, it's recommended the default is used.

Where the average of the costs applied by the comparator schemes is higher than the existing scheme, the verdict is the existing scheme is good value. However, where the existing scheme has higher charges than the average applied by the comparators, the existing scheme might not be deemed to provide good VFM (subject to the other criteria).

2. Net Investment Returns

The reporting of net performance is recommended to take account of both the short term and longer term performance timescales, so comparisons over 1, 5, 10 and 15 years are recommended. For open schemes, the majority of assets are typically invested in the default and the greatest focus should be applied to these funds. If there's no default, then focus should be placed on those funds most heavily used, but net investment returns are still required for self-select funds.

The DWP guidance suggests the comparison can be limited to the "most popular self-select funds" though this isn't defined so there's the opportunity for some interpretation.

Data should take account of annualised net returns over the periods described above. Where the investments change over time, for example in line with a lifestyle strategy, savers of different ages must be considered – suggested ages are 25, 45 and 55. However, the impact of fixed administration fees hasn't been considered in the DWP guidance.

While finding the comparable data is relatively straightforward, it might be more challenging to get the data on your existing default and self-select funds in the recommended format.

Working on historic data to provide the correct format could be a time-consuming (and expensive) exercise. The format prescribed in the DWP guidance is new and may not reflect the reporting previously provided. The data may require some unravelling and re-configuring to show the default fund as a whole instead of the individual elements. Reporting on a net basis may also be new, so the new combined funds may require additional work to reflect the charges.

Reporting net performance on self-select funds is less likely to be an issue, but it does depend if the reporting has been done previously on a gross or net basis. It'll also be important to try to find comparators with similar funds as if there are none in your comparator's list, the self-select fund will have to be compared against the default fund – arguably not a useful comparison.

There's also the tricky issue of fees changing as savers approach retirement and the impact of fixed administration fees will typically not be factored into investment returns. Actuarial support may be required to work these issues out and provide a meaningful data set.

The result of this is the first year of reporting will be the most difficult, time-consuming and expensive. Finding a comparator with similar funds, sorting out the historic data to display in an acceptable format and getting your With-Profits provider to publish useful data will probably be more challenging than most trustees expect.

Once the first year has been completed, future years should be more straightforward – of course if you have managed to pass the tests.

3. Governance & Administration

This could be considered the most in-depth section to complete and requires the most data collation. The summary of the requirements are:

- Trustees must assess governance and administration as part of their assessment of value
- The assessment about governance and administration doesn't need to be made against comparator schemes in the same way as the costs and charges and net investment return assessments do
- Responsibility lies with the trustees, even where tasks are delegated

This area is split into 7 metrics:

1 Promptness and accuracy of core financial transactions

Evidence needs to be supplied to show transactions meet these requirements, and guidance is given as to which areas are most significant:

- Payment in and investment of saver and employer contributions
- Transfers between schemes
- Transfers and switches between investments within a scheme
- Payments out of the scheme to beneficiaries

Trustees will need reporting statistics from the scheme administrator which captures transactional data analysis and a summary of related complaints. This could form part of the governance reporting cycle or, alternatively, an annual assessment undertaken by a third-party.

Consideration could also be given to simple analysis software which can run automatically and 'audit' contributions. Tolerances such as the levels of inaccuracy tolerated, and the mitigating action on exceeding thresholds should also be considered.

2 Quality of record-keeping

The main areas of focus here are security of data, accuracy of data, audit and review of data, evidence of compliance with the Data Protection Act and strategies and processes for business continuity and cyber risk. The PASA guidance on DC Governance covers much of the practical detail of day-to-day processes addressing these issues.

There's a long list of items and evidence of compliance with these requirements, or robustness of processes, doesn't necessarily link directly to Value for Money . The intelligent response may be to show how monitoring and audit can link back to good VFM. For example, levels of complaints related to data security or showing how the business continuity plan protects maintenance of customer services.

3 Appropriateness of the default investment strategy

The focus here is on the process of decision-making sitting around the investment strategy.

Legal requirements are for:

- Chair of trustees to include the most recent Statement of Investment Principles (SIP) for the default arrangement in the annual Chair's Statement
- Detailed reviews of the SIP for the default during the previous 12 months (and explanations for any changes made as a result of any such reviews)
- Where no reviews of the SIP for the default have been undertaken, the date of the last review

When assessing VFM the following should be considered:

- Appropriateness of each stage of the saver journey
- Consistency of application of the strategy
- Value added from portfolio construction, asset allocation and manager selection
- Risk and return is suitable for the objectives of the scheme and the demographic profile of the savers
- Policies on ESG and climate change risks are tailored to the investment strategy of the scheme or fund

There's no mention of cost in connection to the requirements but clearly this must be considered.

There's also no mention of whether multi-employer schemes such as master trusts - need to view their investment strategy in terms of the whole membership or as discrete employer segments.

4 Quality of Investment Governance

This aspect reinforces trustees' responsibility to secure proper investment management with particular reference to economic shocks affecting the value of pension assets.

In relationship to VFM the following needs to be considered:

- Governance procedures are well documented and adhered to
- All trustees are clear about their role and level of authority in decision making
- Delegated tasks are carried out by individuals with the required knowledge and expertise to perform their role competently
- Where fiduciary managers and investment managers are used, the trustees must remain actively engaged
- The trustee as a whole has the knowledge and competence to oversee and challenge investment effectively
- Regular reviewing of fund performance against objectives
- Trustees recognise the role they play in asset allocation, setting investment strategy
- The selection, monitoring and retention, of managers
- Risk management and continuity plans in place to deal with economic crises and market volatility
- The long-term financial sustainability of investments including consideration of climate change and ESG factors
- Oversight of communication strategies used to keep savers informed about investment options

It would be prudent to complete an audit identifying gaps in the current investment governance structure in reference to the above. Where gaps are identified, the costs of addressing these gaps, and the potential impact upon saver fees, should be considered.

In some cases it may not be practical for trustees or sponsoring employers to absorb the cost of upgrading these structures to meet the requirements and a trade-off will need to be made between the quality of service and the cost to the savber.

5 Level of trustee knowledge, understanding and skills to operate the pension scheme effectively

This section is about the knowledge, understanding and skills of the trustee board and how it can impact saver outcomes. The Pensions Act 2004 sets out the legislative requirements trustees of occupational pension schemes must meet and TPR also provides guidance on trustee knowledge and understanding. Trustees should assess and explain how well their scheme has performed against these requirements, including considering the below:

Whether sufficient time is spent running the scheme

- Quarterly trustee meetings
- Diversity of trustees in terms of background, experience and skills
- A range of skills, experiences and backgrounds should be evident and should be relevant to the needs of the scheme

Quality of leadership and effectiveness of board decision making

- The chair of trustees should be able to demonstrate effective leadership skills
- The performance and effectiveness of the board should be evaluated annually

Trustee Continuous Learning and Development

- Trustees must show they have the necessary knowledge and understanding to carry out their role and act in the best interest of their savers
- Trustees should keep a record of training undertaken and plans for future training

Quality of working relationships with employer/third parties

- The performance of advisers and providers should be reviewed at least quarterly for most schemes
- Trustees should be in regular contact with the employer

Schemes should be able to demonstrate compliance with these requirements and there should be no case for charging savers additional costs in order to meet these.

6 Quality of communication with scheme savers

The Disclosure Regulations set out the minimum information which must be communicated to savers. The following should also be considered by trustees as part of the assessment of the quality of communications with savers:

- Information should be given to savers in an accurate, clear and concise way which is easy for them to understand. How well this is done could be assessed by feedback from savers, including any complaints about quality and quantity of information received. In addition, simple reading age checks can be carried out to assess clarity of communications
- Savers individual preferences of communication methods should be acknowledged and technology and digital platforms used appropriately
- Quality and timeliness of information in:
  - Information and guidance in relation to the rights to transfer to another scheme
  - Quality of guidance on spotting potential scams
  - Information to help with decision making on investment options
  - Information in the retirement wake up pack
  - General signposting of savers to various guidance bodies
  - Information to help with decision making on pension saving, including, for example, an indication of the value at retirement and the impact of contribution levels on that value

To have demonstrated good value in this area we expect trustees to have concluded they have met their statutory obligations, as well as explaining how they've met the expectations in points above.

7 **Effectiveness for management of conflicts of interest**

Conflicts of interest can arise among anyone involved with the pension scheme. The pension scheme should therefore have:

- A robust policy and written procedures which are regularly reviewed to identify, manage and monitor conflicts of interest effectively
- Controls in place to ensure all trustees are aware of the requirement to declare and discuss any potential conflicts
- A conflicts of interest register to record and declare interests, which is discussed at every meeting
- Controls in place to ensure all conflicts of interest are declared upon appointment

Trustees are expected to have all four points in place and be able to show they've been followed to demonstrate they've achieved VFM in their management of conflicts of interest.

3. Conclusion

The list isn't exhaustive – you might want to consider other appropriate metrics, but you should explain their relevance to VFM.

Satisfying the requirements for VFM will challenge many trustees and could prove an expensive exercise. Balancing out the various factors to conclude if a scheme can truly state it provides VFM may be subjective and the interpretation may be up for debate.

DWP's expectation is trustees shouldn't give excessive weight to costs and charges in their assessment and greater weight should be given to net investment returns and the performance on governance and administration (para 114). This is helpful in emphasising it isn't a race to the bottom in terms of costs and charges. However, DWP also expects schemes won't be able to conclude they're delivering VFM where costs and charges are 'significantly' higher than a comparator scheme unless there is a 'demonstrable, material difference in governance and/or investment return' (para 115)

Visit us on Stand 827 at PLSA 12-13 October, members of the DC Governance Working Group will be available to chat to during the conference.

Look out for the next edition covering transfers and the thorny topic of anti-scamming processes.

We'll be sharing our thoughts on our new podcast service, so please tune in!

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