PASA DCWG

Value for Money assessment and Reporting Investment Returns

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1. Introduction

This paper details concerns over the practical application of the VFM mechanism for DC schemes. PASA is keen to work with TPR to look at how its future guidance and metrics could be developed to provide practical support to schemes and their administrators. We've identified several areas of VFM requirements needing careful consideration to ensure any solutions are workable and deliver on the desired outcome of the VFM requirement.

New Value for Money reporting requirements were introduced from 05 October 2021 for relevant occupational pension schemes with under £100 million of assets. The increased reporting and assessments have been widely reported and this paper comments on some of the issues faced by trustees in preparing the Chair's Statement. There are three areas under consideration which have been commented on separately:

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

2. Costs and charges

Of the three new requirements, this is arguably the easiest section to complete.

The DWP (statutory) guidance on completing the annual Value for Money assessment and Reporting of Net Investment Returns, published 21 June 2021 sets out the reporting requirement 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 in a transfer, so in practice, we expect one would be a master trust.

Comparing the existing scheme charges to the comparators, including the scheme which has expressed their agreement in principle to accepting your scheme, is the next step and there's a suggested format for reporting these charges, as below:

Scheme	Charges	Transaction costs	Total costs and charges
Existing scheme default fund			
Comparator 1			
Comparator 2			
Comparator 3			

The DWP Guidance recommends this should be repeated for the self-select funds as well as the default fund.

In many schemes this is straightforward, but there may be some complications. Below are some examples of complications and suggestions on how to deal with them:

If there's a flat administration charge applied to each saver (e.g. £50 per saver p.a.) this results in a disproportionate cost to savers with smaller fund sizes and schemes might need to adjust the charge 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 the very least just using the median pot size if only one is used. (Paragraph 44 of Reporting of costs, charges and other information: guidance for trustees and managers of occupational schemes – effective from 1 October 2021 - GOV.UK (www.gov.uk)) although there's no mention of how these charges should be reported.

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

The issue has been addressed in the DWP statutory guidance on completing the annual Value for Money assessment and Reporting of Net Investment Returns dated 21 June 2021. Schemes can report across different age groups and it's suggested at 10-year intervals

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

We're not aware of many With Profits funds used as a default investment option in DC schemes although some are used in AVC arrangements. However, there are a number of self-select With Profits options available. The reporting requirement is more difficult as 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 from the With Profits fund isn't available.

Who pays the charges?

Administration costs aren't universally paid by savers across all DC schemes. Where the employer pays some or all the charges, it could improve the value to savers. 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.

In the case of comparison of default funds, it's recommended by DWP the scheme's default fund is compared with the default funds of the comparator schemes, even if the investment profile is different. In the case of self-select funds, it's recommended the scheme compares against the nearest comparable funds of the comparator schemes. The DWP Guidance acknowledges for certain self-select funds there may not be any comparable funds in the comparator schemes (e.g. with-profits or legacy funds). In this case, it's recommended the default fund costs and charges should be 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 Value for Money (subject to the other criteria).

The default fund should carry a greater weight than self-select funds, but when choosing the comparator schemes, it's useful to choose schemes providing a similar choice of funds or a fair comparison will be difficult.

3. 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 active schemes, the majority of assets are typically invested in default funds, the greatest focus should therefore be applied to these funds. However, increasingly, occupational DC schemes have been superseded by alternative schemes (such as Master Trusts or Group Personal Pension schemes) and this results in a proportion of schemes with no default fund. In these cases, 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, although this isn't reflected in the legislation. The term 'most popular self-select fund' isn't specifically explained so there's opportunity for some interpretation.

As with the previous section, some examples of how this data should be presented have been published and reflecting it in this way may be challenging for trustees.

The 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 in the guidance are 25, 45 and 55.

The impact of fixed administration fees has not been considered in the Guidance.

Some typical questions asked by schemes with regard to completing this are:

- We changed our investment advisers 2 years ago and the historic performance data we have doesn't show the level of detail we need to complete the returns. How do we account for this?
- We amended the investment strategy and charges last year; how do we reflect this in the data?
- The default fund is a With Profits fund – how can we find out the net performance on this?
- Our data shows the individual gross performance of each fund used in our default strategy; how do we complete the returns?
- Charges vary depending on the age of the saver and their proximity to retirement, how do we reflect this?
- What about the fixed administration costs, how do we factor them into the net returns – they are different proportionally for savers with smaller/larger fund sizes?

Although finding the comparable data is relatively straightforward, these questions demonstrate 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 statutory Guidance is new and may not reflect the reporting previously provided. For trustees who don't have this information, this doesn’t mean they’ve been doing anything wrong – but moving forward, the requirements have become more defined and the reporting more specific.

This historic data may require some unravelling and re-configuring to show the default fund as a whole instead of the individual constituents. Reporting on a net basis may also be new, so the new combined funds may need to have some additional investigation and re-presentation to reflect the charges.

Reporting net performance on self-select funds is less likely to be an issue, but it does depend on 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 which 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 – if you’ve managed to pass these tests.

4. Governance and administration

Summary of requirements

- Trustees must assess governance and administration as part of their assessment of value
- The assessment of governance and administration conducted as part of the value for money assessment doesn’t need to be made against comparator schemes in the same way as the costs and charges and net investment return assessment
- Specifically, this should be linked to good investment outcomes and used to build trust and confidence with savers

- Responsibility lies with the trustees, even where tasks are delegated

The regulations split the requirements down into **7 metrics**:

1 **Promptness and accuracy of core financial transactions**	2 **Quality of record-keeping**	3 **Appropriateness of the default investment strategy**
4 **Quality of Investment Governance**	5 **Level of trustee knowledge, understanding and skills to operate the pension scheme effectively**	6 **Quality of communication with scheme savers**
	7 **Effectiveness of management of conflicts of interest**	

This list is not exhaustive – other metrics may also be appropriate but the relevance to VFM should be explained.

5. Commentary on the seven metrics and key questions

Promptness and accuracy of core financial transactions

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

A. Payment in and investment of saver and employer contributions
B. Transfers between schemes
C. Transfers and switches between investments within a scheme
D. Payments out of the scheme to beneficiaries

They also point towards out of market risks and the impact on saver returns of getting this wrong.

Trustees will need reporting statistics from the scheme administrator capturing transactional data analysis, in addition to a summary of related complaints relating to these specific areas. This could form part of the governance reporting cycle or, an annual assessment undertaken by a third-party. Consideration could also be given to simple analysis software which can run automatically and 'audit' contributions, a key risk area. Thought also needs to be given to tolerances – what levels of inaccuracy would be tolerated and what would be the mitigating action to be taken where these thresholds were exceeded?

Quality of record-keeping

Main areas of focus here are all data-focused; security, accuracy, audit and review of data.

Evidence is needed of compliance with the Data Protection Act, 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. This is quite 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 ('VFM'). The intelligent response may be to present a view of these controls showing how monitoring and auditing can link back to good value for savers.

For example:

- Levels of complaints related to data security
- How the business continuity plan protects maintenance of customer services

Trustees are also required to evidence accuracy and scope of data.

Default fund strategy

The focus is on the process of *decision-making* which sits 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
- Detail any reviews of the SIP for the default arrangement taking place in the previous 12 months. If changes have been made as a result of any such reviews, explain those too
- Where no reviews of the SIP for the default arrangement have been undertaken, provide the date of the last review

When assessing VFM/value for money in relation to investment strategy the following should be considered:

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

While all the requirements are sensible, it’s difficult to make the connection between these finely-tuned assessments and value for money. Obviously, cost must be considered despite there being no mention of it in the requirements.

For example, ESG strategy varies significantly between manager and providers. Large, multi-employer schemes can deliver economies of scale through sheer size and this can reflect in highly competent investment management and ESG strategies which are appropriate for a broad range of savers. Smaller schemes will find it very difficult to compete in terms of price while maintaining the need to tailor the strategy to a specific membership. Although the issue may be mitigated by better knowledge of their membership.

The question around multi-employer schemes such as Master Trusts is - would they be required to view their investment strategy in terms of the whole membership or as discrete employer segments? Often, Master Trusts will price employer segments individually so the relationship between the points addressed above and the cost of the product for a particular participating group could vary significantly. his appears not to have been addressed in this DWP Guidance but Master Trusts will be very aware they’ll be held to higher standards than other DC arrangements over time.

Quality of Investment Governance

The requirements reinforce the trustees’ responsibility to secure proper investment management with reference to economic shocks affecting the value of pension assets.

In connection to VFM/value for money the following should be taken into consideration by the trustees:

- Governance procedures are well documented and adhered to
- Where there’s more than one trustee, each member is clear about their role and level of authority in decision making
- Delegated tasks are carried out by individuals who have the required knowledge and expertise to perform their role competently, in line with the legislation
- Where fiduciary managers and investment managers are used, the trustees must remain actively engaged
- The trustee board 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 and 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 the communication strategies used to keep savers informed about their investment options

Again, while all good practice, the link between this being done well and cost to the saver isn't clear. It appears an audit would need to take place to identify gaps in the current investment governance structure in reference to the above requirements. Where gaps are identified, the costs of addressing these gaps and potential impact on saver fees would need to 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 saver. There's no guidance on how schemes and trustees should approach these considerations, so trustees have some flexibility in this area.

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

This section is predominantly 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 reference to the following TPR requirements and guidelines:

Whether sufficient time is spent running the scheme

- Quarterly board meetings
- Diversity of trustee board - a range of skills, experiences and backgrounds should be evident on the Board – and these *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

- Boards must demonstrate trustees 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
- Trustees should be in regular contact with the employer

As with other elements of the guidance, there's little linking these requirements with value or cost. In essence, it reiterates the legislative requirements of the Pensions Act 2004. Value implies a dynamic between cost and quality. It's a requirement for all schemes to show they're adhering to these directives so there's little differentiation which doesn't allow much opportunity for demonstrating greater value for money.

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 them. There shouldn't be a direct correlation with costs or value.

Quality of communication with scheme savers

The Disclosure Regulations set out the type of information which must be communicated to scheme savers by trustees as a minimum.

The following should be considered by trustees as part of an assessment of the quality of communications with savers:

I. Information should be given to scheme 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 scheme savers, including the number of complaints about quality and quantity of information received. In addition, simple reading age checks can be carried out to assess clarity of communications
II. Scheme savers' individual preferences for mode of communication should be acknowledged and technology and digital platforms used as appropriate
III. The quality and timeliness of information in the following areas:
    - Information and guidance in relation to the rights to transfer to another scheme
    - The 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've met their statutory obligations and explained how they've met the expectations in points (i) to (iii) above.

Effectiveness of management of conflicts of interest

Conflicts of interest may arise either among trustees, between trustees and the employer or scheme provider, or with service providers and advisers.

The pension scheme should therefore have:

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

Trustees are expected to have all 4 of points in place and be able to show they are effective in practice to demonstrate they've achieved value for money in their management of conflicts of interest.

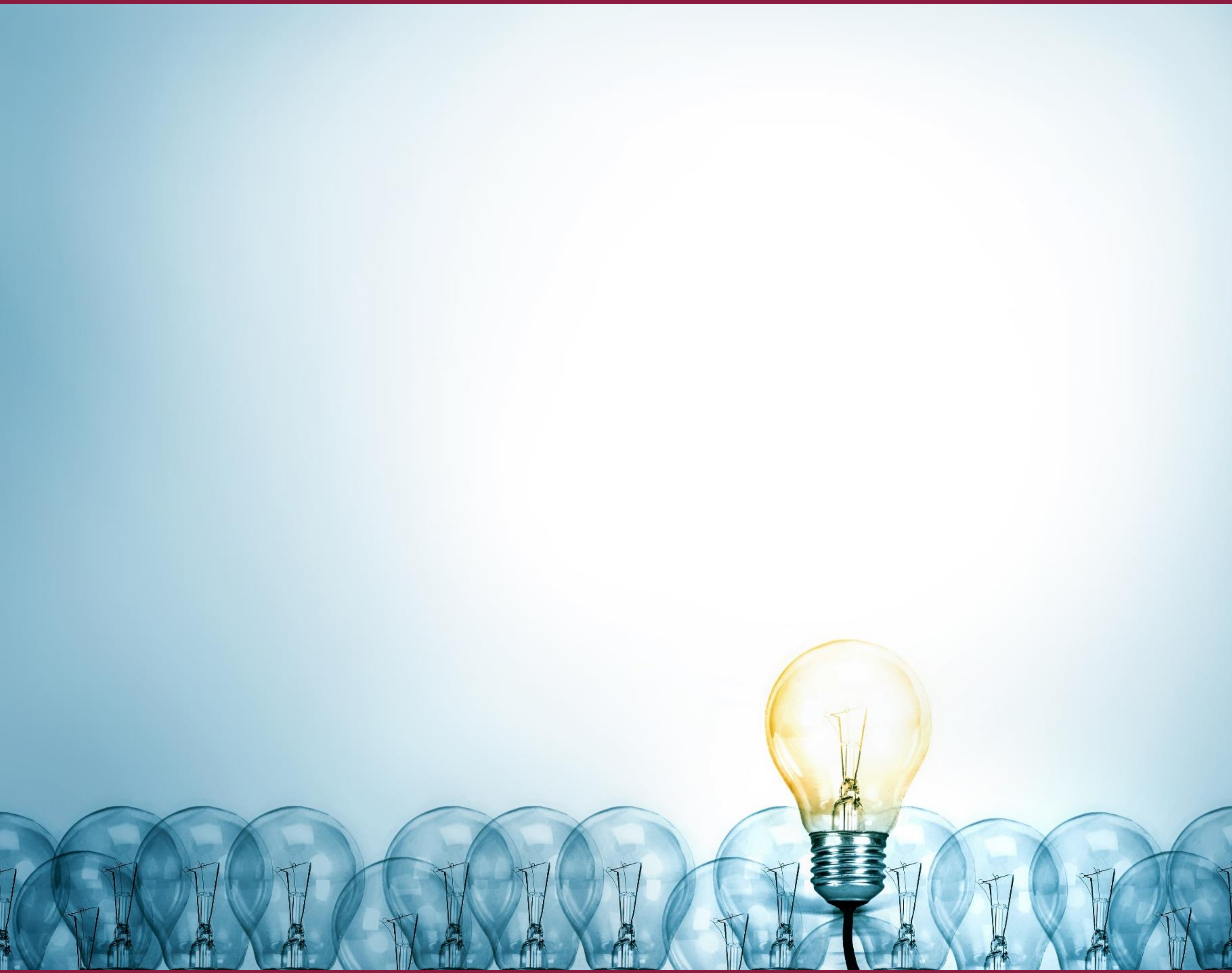
6. Conclusion

Satisfying the requirements of this new legislation 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 Value for Money may be subjective and this interpretation may be up for debate.

The DWP says "Driving down costs should not be at the expense of data quality or operational sustainability" (paragraph 114). The 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 performance on governance and administration. This is helpful in emphasising it isn't a race to the bottom in terms of costs and charges. However, the DWP also expects schemes won't be able to conclude they're delivering value to savers where costs and charges are "significantly" higher than a comparator scheme unless there's a "demonstrable, material difference in governance and/or investment return" (paragraph 115).

On a final note, this additional reporting is likely to significantly increase the size of the Chairs' statement and there's a risk the resultant document will be largely left unread by many savers. Consideration may be given in the future as to how this could be provided in a condensed format to help savers understand and raise awareness of the work being done to protect their retirement benefits.

PASA is creating a working group to take this forward as further consultations and information becomes available. It's the intention of this group to work closely with TPR to ensure practical and workable solutions are in place without diluting the intention of DWP's drive for VFM/value for money.



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