Value for money and default funds in a flexible world

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Currently, the regulatory focus on 'value for money' and default fund design in both trust and contract-based defined contribution (DC) schemes is aimed at improving 'member outcomes'.

However, we are yet to see any mandatory guidance defining what these terms mean.

PSIT have been providing trustee and governance services to occupational trust-based pension schemes for 20 years. We see clear parallels with a trustee's fiduciary duty to act in the best interests of scheme members and the need to obtain value for money for members of contract-based schemes. The **need for governance and value for money expertise pervades the management of all pension schemes** from trustee boards to independent governance committees (IGCs) and governance advisory arrangements (GAA) for workplace pensions.

Regulatory requirements

For trust-based schemes, the Pensions Regulator issued Code of Practice 13 and associated guidance in November 2013. This requires trustees to assess their DC arrangements against **6 key principles and 31 quality features**, and explain how their scheme complies by publishing their first governance statement by the end of the 2014/15 scheme year. For contract-based schemes, the Financial Conduct Authority's (FCA) recent Policy Statement (PS15/3) sets out requirements for IGCs to **assess value for money** and **challenge providers to improve their products**, where necessary.

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One might justifiably say the new rules are long overdue. Many members of contract-based schemes are trapped in **high charging - and often unmonitored - legacy products** that offer poor value for money and poor member outcomes. In the trust-based world where many schemes have both DC and defined benefit (DB) elements, **some trustees have been guilty of relegating discussions about DC benefits** to second place behind the challenges presented by the DB section. Similarly, many DB-only schemes have an additional voluntary contribution (AVC) option that may not have been reviewed or monitored as closely as it deserves.

Both the Regulator and FCA agree there is no common definition of what constitutes value for money. The reality is various stakeholders will place different values on the components to be assessed. For those responsible for governance, balancing these different values can be a tricky task.

The challenges ahead

The pensions industry has been delivered a difficult task in determining value for money. Fortunately, it appears some scope is available to trustees and workplace pension governance committees to **take into account the dynamics and perceived requirements of a scheme's particular membership**. Regulations due to come into force on 6 April 2015 may provide some clarity (the snappily named Occupational Pension Schemes (Charges and Governance) Regulations 2015).

Whilst delivering value for money is one priority, the government's decision to provide members with more choice in how to take their benefits is another. Without the obligation to purchase an annuity, **the question of what is an appropriate default fund has become more complex**. The default is, after all, one of the most significant factors in maximising outcomes where members do not make their own investment choice.

We expect there will be a **greater use of diversified investment products** in future default arrangements. However, this needs to be balanced against the additional costs of using any investment vehicle that is more than a simple default fund.

Our value for money wish list

Value for money will mean different things to different members, but there are some clear building blocks that can be used as the foundation. Underpinning these will be an optimal scheme design that is sustainable over both the accumulation and decumulation period. The weighting placed on each component will be a matter of judgment. In our view, value for money is a combination of factors, including:

- an appropriate total expense ratio (TER) - below the proposed default fund charge cap and proportionate for other fund choices
- the ability to access a range of funds - including new multi-asset default arrangements
- effective, plain English member communications - focusing on articulating risks and outcomes and leading to clarity of information on choices
- an excellent administration platform, holding accurate member data - ideally web-based for members to review their choices and model outcomes
- appropriate options at the retirement or decumulation phases - with support and guidance available to members

Whilst costs and charges are important, they are only one factor to consider. The **lowest costs will not necessarily provide the best outcomes**. Higher costs can be justified if benefits are improved - and this something we should not be scared of.

Other considerations

Both the Regulator and FCA have suggested **members should be given an opportunity to put forward their view** of what value for money means to them. We agree it is important to provide a forum to encourage members to comment and to act on the feedback received. However, successfully engaging members to provide that feedback is an ongoing challenge.

Transparency of costs is also essential. The ability to get beneath the bonnet and understand the charging structure of often complex funds is essential and is especially relevant to some legacy products.

DC schemes or products offering the best value for money will be those where **the costs of membership** (i.e. the costs and charges deducted from members' pots or contributions) **provide good value in relation to the benefits and support services provided**, including when compared to other investment and savings options available in the market. It will be for DC scheme trustees and IGC/GAA chairs to rise to the challenges and ensure their arrangements are not only fit for purpose but also truly beneficial for members.

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