INVESCO RETIREMENT SERIES – PART 5

A closer look at the proposed Value for Money framework for DC workplace pensions

Overview

Following extensive engagement with stakeholders, the UK government, The Pensions Regulator (TPR), and the Financial Conduct Authority (FCA) are proposing a joint Value for Money (VfM) framework for default defined contribution (DC) workplace pension arrangements with the collective aim of ensuring that such arrangements operate more effectively in the long-term best interests of members.

Michael O'Shea
Director, Government Relations and Public Policy

The FCA is consulting on the details of the framework, proposing a number of regulatory measures which seek to enhance scrutiny over default and "quasi-default"[1] arrangements, with certain exemptions, and to introduce new requirements for arrangements that are underperforming across various metrics relative to their peers.

In short, the FCA is proposing:

1. Greater transparency around arrangements' investment performance, quality of services, and costs and charges, as well as asset allocation
2. To strengthen existing assessment of value processes by requiring regular and objective comparisons with other in-scope arrangements against a range of metrics
3. Public disclosure of the outcomes of such assessments alongside an arrangement's 'RAG' (red, amber, or green) rating
4. Specific actions to be taken where arrangements are deemed not to be delivering value to members (i.e., where they are rated 'amber' or 'red')

While the proposed framework would apply to most DC workplace pensions, the FCA's rules and guidance would apply specifically to in-scope contract-based schemes, with the government having announced that it will legislate in due course for the same VfM framework to apply to relevant TPR-regulated trust-based schemes.

As a result, no specific timeline has been set for the implementation of enabling legislation nor, therefore, the application of the framework itself. However, we know that pensions reform is a priority policy area for the new Labour government, and it may be that the Pension Schemes Bill, as announced in the King's Speech, provides the legislative opportunity to introduce the VfM framework.

The FCA consultation runs until 17 October and will be supplemented by further stakeholder roundtables and events.

[1] The FCA define a "quasi-default" offering as an "arrangement… used by at least 80% of employees and ex-employees (active and deferred) of at least 1 employer in the arrangement."

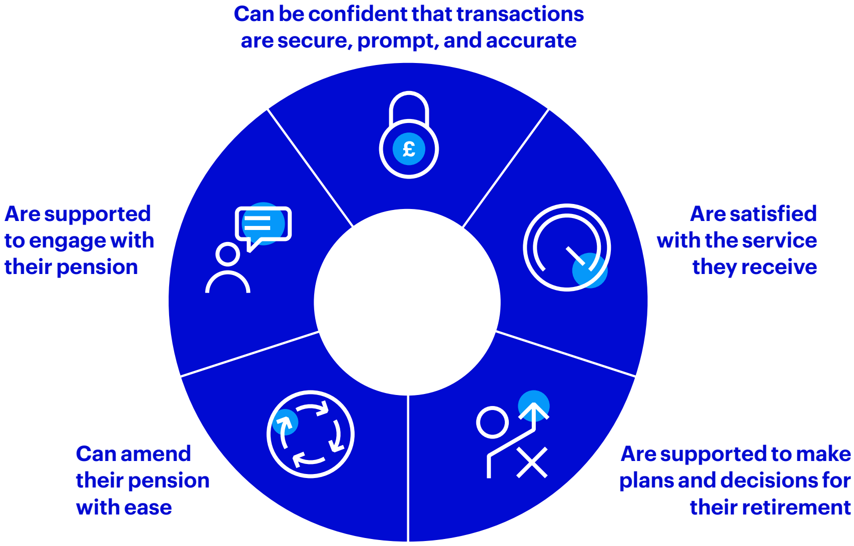
A closer look at the VfM framework

1. Transparency

1.1 Investment performance
To assess an in-scope arrangement's performance, the FCA proposes transparency around specific backward-looking data points and risk metrics. These include, for example, gross investment performance net of transaction costs, investment charges, and all costs and charges, respectively, as well as an arrangement's annualised standard deviation (ASD)[2] and maximum drawdown. The proposals also include a requirement to apply a chain-linking methodology when calculating historical investment performance where scheme members have been moved into a new arrangement within the same firm.

The FCA has not proposed to include any forward-looking metrics within the VfM framework, though it has committed to undertaking further work relating to the potential inclusion of projections of expected future risk-adjusted performance as part of broader transparency requirements.

1.2 Quality of service
Based on feedback received from stakeholders, the FCA has identified five potential indicators which could be used as a means to measure the quality of service provided across in-scope DC workplace pensions. The proposed indicators aim to gather information on whether pension savers:



While the FCA acknowledges the challenges inherent to measuring service quality, the intention is that, by collecting basic quantitative data on the above metrics, those responsible for the governance of in-scope arrangements will have enough information to form an objective view on the overall quality of service provided relative to cost.

[2] The FCA states that ASD measures "performance volatility by looking at how much an investment's returns vary around the average return over a specific period. A fund with a higher ASD has more price volatility over the period, and may carry more risk."

1.3 Costs and charges

The FCA proposes that firms disclose total costs and charges paid by members and their employers, including investment charges and service costs. Investment charges would be those accrued in relation to an in-scope arrangement's investments, excluding transaction costs,[3] while service costs would include, for example, member administration, communications, and governance costs, and be broadly defined as "total costs and charges less investment charges (and excluding transaction costs)".

Firms would be required to use the same calculation methodology to ensure consistency and comparability, with those vertically integrating investment and other related services required to unbundle the costs to associated arrangements.

1.4 Asset allocation

While not directly part of the VfM assessment process, the FCA proposes that firm-designed arrangements disclose their asset allocations in line with rules that already apply to trust-based schemes. This should provide data on allocations across key asset classes, including equity (listed and private), bonds, property, infrastructure, private debt, and cash, and relevant sub-categories, as well as allocations to "UK assets" for which the FCA has proposed a detailed definition relevant to each asset class.[4]

The intention is that, by providing greater transparency on in-scope arrangements' asset allocations, market participants will be able to better understand the impact that certain allocations have on returns, in particular allocations to less liquid and alternative assets, and to consider whether such assets would be appropriate for inclusion within a greater number of portfolios.

2. Assessment

The FCA proposes a four-step process for assessing an arrangement's VfM which Independent Governance Committees (IGCs), Governance Advisory Arrangements (GAAs), and trustees, as appropriate, would be expected to follow. An overview is provided below:

Step 1	**Value delivered from investment performance** Comparison and assessment of returns net of investment charges, taking account of investment risk
Step 2	**Value delivered from services** Comparison and assessment of service quality relative to service cost
Step 3	**Provisional overall value** Comparison and assessment of returns net of all costs, together with findings from Steps 1 and 2
Step 4	**RAG determination** Further contextualisation for a decision on VfM; if not VfM then agree on planned improvements

Arrangements deemed to be underdelivering on value will be assigned an 'amber' or 'red' rating and those responsible for the assessment will be required to engage with relevant firms to determine the remedial actions required to address the "shortfall" in value.

'Amber' ratings should only be assigned where the proposed remedial actions are expected to deliver VfM within two years. As such, receiving a 'red' rating would mean that the value delivered to members by an arrangement cannot or will not be improved "within a reasonable period of time" (i.e., two years).

[3] The FCA has proposed specific provisions for vertically integrated providers.
[4] UK assets could include listed investments with a primary listing on a UK market; UK exposures within pooled funds (including global equity funds); private equity assets that comprise underlying investments in UK-registered private companies; infrastructure and property assets located in the UK; private credit assets that relate to borrowers located in UK etc.

3. Disclosure

The VfM framework would require firms to publish on an annual basis (e.g., in the Independent Governance Committee's annual report) data relating to investment performance, quality of service, costs and charges, and asset allocation for each in-scope arrangement.

The FCA proposes to expand on existing disclosure requirements applying to those responsible for the governance of in-scope arrangements to include the VfM assessments themselves (including VfM data, contextual details, and actions to address poor value), as well as:

- a cross-arrangement overview of key themes across in-scope arrangements overseen
- an explanation of the choice of comparator arrangements, justifying any different choices for specific arrangements
- an explanation of how the firm's scale has been considered within the VfM assessment

Though not a requirement, the FCA states that firms may also want to include an explanation of how environmental, social, and governance (ESG) issues are taken into account across in-scope arrangements.

4. Action

The FCA proposes that arrangements rated 'amber' or 'red' be required to communicate their rating with employers within one month of receipt, setting out the remedial actions that will be taken to address the shortfall in value alongside any relevant recommendations for the employer itself in respect of the arrangement. Such arrangements would also be closed to new business until they are assessed as delivering value to members.

Similarly, firms managing such arrangements would be required to notify the regulator within five working days of receiving such a rating and to submit an action plan setting out how they intend to provide value to members.

For 'red'-rated arrangements, the FCA proposes that firms consider transferring members to alternative in-scope arrangements determined to be delivering value. Where it is not possible to move members to an alternative arrangement (e.g., members have not consented to being transferred), firms will be required to implement additional protections for members to mitigate the poor value being delivered, for example by reducing fees.

The FCA notes that the need for consent to transfer members from an underperforming arrangement to arrangement delivering value may present a challenge to those managing 'red'-rated arrangements. The FCA notes that the government may legislate to enable such transfers without consent, internally or to another provider, while maintaining appropriate protections. However, the government has yet to take a decision in this regard, hence additional mitigations, such as a reduction in fees, would be expected in the interim.

'Red'-rated arrangements would be required to consider transferring members to alternative in-scope arrangements determined to be delivering value.

Future focus

The FCA also points to some areas of potential future focus, including requiring more direct regulatory interventions for underperforming arrangements, establishing benchmarks against which an arrangement's value could be measured, and integrating VfM metrics within pensions dashboards.

The regulator also references the potential to extend the scope of the framework to encompass non-workplace pensions and even decumulation solutions to ensure that any pension product provides value.

The FCA makes clear, however, that any such additional measures would only be fully considered once the VfM framework, as described above, had been implemented and shown to be effective.

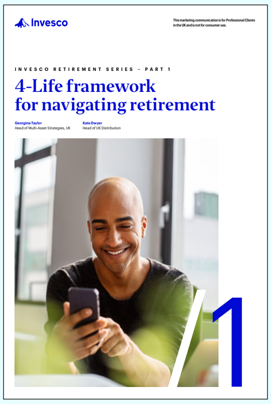
With the FCA consultation closing in mid-October and more details of the Pension Schemes Bill and broader pensions review expected in due course, it is important that all interested parties – employers, members, pension providers, trustees etc. – engage with the additional stakeholder roundtables and events planned by the FCA, TPR, and the DWP as measures to establish the joint framework for default DC workplace pensions are taken forward.

Please see our Retirement Series

In the previous papers in our Retirement Series we introduce the 4-Life decision making framework, explore the opportunities for combining a guaranteed income with investment growth and provide an analysis of both the Retirement Advice Review and Labour's Pensions Schemes Bill.

You can read the papers here:

Part 1



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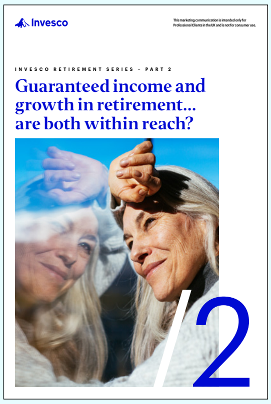

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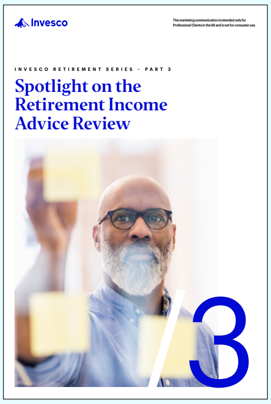

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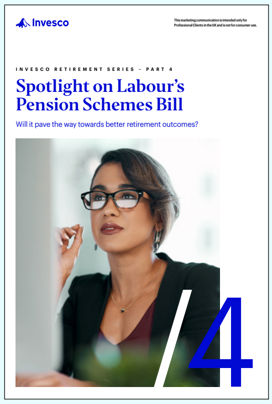

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and you may not get back the full amount invested. Over time, inflation may erode the value of investments.

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