tPR & FCA – Driving Value for Money in defined contribution pensions

Response from Nest Corporation

1 About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Unlike any other pension scheme in the UK, Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 940,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high quality, low cost pension scheme helping over 10.6 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £19,400 per year and over 55% our members are aged under 40 years old.[1]

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We now occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.

[1] Employer and member numbers correct as of 28/11/21, Nest in Numbers; Member earnings and age data correct as of 30/04/21, quarterly briefing data pack, Scheme MI

2 Response

Introductory comments

Nest welcomes this discussion paper from the FCA and tPR. We agree that VfM across the industry is inconsistent, and that the development of a common framework to assess the main components of VfM has the potential to help some groups compare between different schemes and providers.

We see Trustees and IGCs as the main audience of the VfM framework outlined in the discussion paper. Whilst some highly engaged employers may also use the information to compare between schemes and providers, these are likely to be in the minority, certainly amongst the mass market employers at which the auto enrolment programme was aimed. Due to behavioural barriers, we also do not believe that at this stage the development of a common disclosure framework for VfM will have a material impact on saver engagement in pension saving. This means (as the discussion document outlines) that a common framework is not likely to lead to improved VfM through a stronger demand side and greater market competition. However, we see benefits for Trustees/IGCs of having more transparent data as a necessary precursor to being able to make VfM comparisons between schemes.

Whilst the development of the framework will take some time to get right, we support the direction of travel that FCA and tPR have set. We agree that investment performance, customer service/scheme oversight, and costs and charges are the major components of VfM. Any disclosure of net investment returns should, on some level, account for the level of risk taken to achieve those returns. It should also account for the disparate member characteristics among schemes. We see these as essential for allowing meaningful comparisons of value. We set out some additional comments in relation to these in our answers to the discussion document questions below.

We urge that any further work on value for money – including the publication of additional performance or charges metrics – should align with DWP's current and prospective regulatory requirements. It is unclear whether the Regulators are suggesting the creation of an additional reporting requirement for occupational schemes beyond the requirements recently consulted on by DWP (requiring reporting of governance and administration considerations for smaller DC occupational schemes and performance and costs for all DC occupational schemes). Requiring different metrics to be disclosed could create further confusion in the market and place additional burdens on Trustees/IGCs.

Regardless of the reporting method chosen, we would also caution against attempting to achieve a "one number" reporting framework for VfM. Whilst this concept has some appeal due to its simplicity, it has significant drawbacks. As noted below, publishing scheme returns by cohort could give a more transparent and granular picture of value by age. This would be lost by trying to create an average "whole of life" return. Moreover, it is not possible to aggregate performance, fees, customer service, and scheme oversight into one definitive number. Finally, net performance can only be evaluated retrospectively, whilst charges are only a guide to – not a predictor of – net return. In short, there is no way of weighting and totalling the components of value to give an objective measure by which one scheme can definitively be said to provide better value than another. The answer will depend on the needs of members, what members themselves value, and the Trustees' estimates of those. The framework employed should account for the current flexibility afforded Trustees.

Finally, we would note the challenge of designing a framework that applies uniformly to both workplace and non-workplace schemes as indicated by the discussion paper. There is inherent value for members saving in workplace schemes who receive employer contributions as compared to non-workplace schemes. A framework that allows for comparisons across these two categories of schemes should recognise and account for this inherent disparity in value.

Investment performance

Question 1: Do you agree that consistent disclosure of performance is necessary to enable better decision making?

Yes, we agree that uniform disclosure of performance metrics is necessary to enable better decision making about VfM by Trustees/IGCs, and some highly engaged employers. We note, however, that this type of disclosure is not likely to be acted on by members, and therefore should not be expected to generate competitive pressure to drive improvement. As further detailed below, net performance should also account for some measure of risk and the nature of a scheme's membership. This latter consideration would include, for example, the membership's risk capacity and required replacement rates.

We would also note that the DWP has already implemented new regulations requiring disclosure of investment performance. As the Regulators are aware, these apply to nearly all occupational DC schemes and DC sections of hybrid schemes. Observing the effects of those regulations on the market should provide some indication of the policy's efficacy. We would urge the Regulators to assess the effects of that policy before intervening again.

Question 2: Do you agree that comparisons should be of net rather than gross investment performance?

We agree that net investment performance provides greater information to the market than gross performance. It is unlikely, however, that reporting net performance will be as straightforward as providing a single net return figure for a scheme – even accounting for different age cohorts and investment funds. The charges incurred by members can vary even within a scheme or fund, complicating the task of uniform reporting. For instance, Nest's charging structure currently includes contribution charges that can vary widely across our membership. It would not be possible to publish a single net performance figure that applies to all members in a particular investment fund. As such, some thought would need to be given to how net performance would be reported.

Question 3: Do you have any suggestions on how to make disclosure of net investment returns effective given that there may be varying charges for the same funds within multi-employer schemes? For example displaying a range, or requiring disclosure of each different level of net investment performance.

Nest does not vary its charges by employer or by any other cohort. Nonetheless, we believe that true price transparency offers the greatest opportunity to improve VfM decisions. We would support requiring disclosure of each level of net performance – and the corresponding charges – achieved by a scheme for various employers. We would urge the FCA and tPR to pay heed to three fundamental principles on costs: 1) if a scheme prices business differentially by employer, it should report those costs differentially by employer; 2) a saver should know the fees they have actually paid and not merely a range of *potential* fees paid; and 3) the transparency of pricing models enhances competition whilst reporting ranges of costs or performance diminish and undermine it. Failing to adhere to these principles would likely allow schemes to obscure performance and charge data to the detriment of delivering comparable and transparent pricing across the sector.

Question 4: Would it be helpful to mirror the DWP's approach in terms of the reporting periods?

Yes. We strongly support tPR and FCA aligning with DWP's approach. We expect that alignment should mitigate confusion within the market and lessen the administrative burden on schemes.

Question 5: Would publishing a set of metrics based on age cohorts bring investment performance reporting closer to the saver's investment performance experience of a pension scheme/product? If not, is there a better alternative we have not considered?

Publishing investment performance metrics based on age cohorts would be useful in allowing for comparison across schemes and products. In line with DWP's recently published guidance, we support

net return reporting by cohort over a single composite measure of returns averaged across all age cohorts, which would be less transparent and less granular. A composite figure would provide less information to Trustees and IGCs.

We would again note that this may still not provide the necessary competitive pressure to improve value across the industry. We think Trustees and IGCs may find these metrics useful for comparing products and supporting their decisions, but equally that the complexity of the metrics reported could detract from their utility.

We would highlight, however, that the disclosure of performance by age cohort could create an opportunity for gaming: for instance, we could envision a situation where Trustees/IGCs could cite the strong performance of investments for a particular age cohort to justify continuing an ongoing investment strategy whilst ignoring the returns for other cohorts. This issue would have to be worked through when considering how any VfM disclosure framework should operate in practice.

Question 6: When considering which age cohorts to consider, is the example we have provided appropriate? Alternatively, would it be more effective to mirror the DWP's approach?

We would reiterate that alignment with DWP would be helpful for minimising complexity in the market and additional administration burdens for schemes. We see no compelling argument for divergence in this area and would thus strongly encourage the Regulators to adopt DWP's requirement to publish net returns for savers aged 25, 45 and 55 where returns vary by age.

Question 7: What disclosures, if any, should be made for self-select options?

For the sake of consistency and allowing comparison of all pension products, we would support requiring the same disclosures for self-select options. This opinion reflects the potential for consumers to compare investment options. We note that DWP regulations currently require publication of performance of self-select options as part of the VfM assessment included in the chair's statement. We would again encourage alignment with that existing requirement.

Question 8: Do you think reporting based on age cohorts would be enhanced through the use of risk-adjusted returns as an element of a scheme's VFM assessment or would risk-adjustment then be unnecessary?

As we have noted in prior consultation responses, we believe that consideration of risk is essential in any assessment of performance. Failing to incorporate risk in an appraisal of performance could enable schemes to game the disclosure metric by seeking short-term returns at the expense of long-term member outcomes.

However, consideration should be given to the way in which risk is communicated. The means by which this is accomplished relates to the intended audience of the framework. As with the reporting of investment performance by age cohort, Trustees and IGCs may (but are not required to) have sufficient expertise to assess risk-adjusted returns and use them to compare products. We believe, however that risk-adjusted returns will prove too difficult for most members and employers to understand. Publishing figures such as Sharpe ratios could therefore breed greater confusion in the market. Indeed, even sophisticated investment professionals may misinterpret some complex metrics.

As a first step, we would encourage the Regulators to consider requiring schemes to publish a separate risk metric. For instance, publications like Corporate Adviser report on risk in this way by charting returns against a volatility metric – the standard deviation of annualised returns.

Although volatility is an imperfect measure of risk, it provides useful information to the market that would allow a more robust comparison than net returns alone. Were DWP to mandate schemes to report on risk, a greater degree of prescription and further work beyond the scope of this consultation would be needed to ensure consistency of reporting. Nevertheless, reporting on performance without risk levels (expressed as volatility or otherwise) will always present a partial picture.

Question 9: If risk-adjustment is used, what risk-adjustment metric(s) would you suggest? For example, the Sharpe ratio as i) a standalone factor, or ii) in combination with other risk metrics?

We are not advocating for producing a single risk-adjusted return figure at this time. Instead, as discussed, we support publishing a volatility measure alongside the annualised return. Incidentally, publishing a standard deviation of annualised returns would provide enough information to the market for benchmarking firms and consultants to calculate their own Sharpe ratios.

Question 10: Is there any reason why it would be impractical to report on risk-adjusted performance metrics in addition to providing a metric based on actual performance returns?

From a scheme perspective, reporting risk-adjusted performance should be feasible. However, as noted in our response to Question 8, there are other considerations surrounding this requirement. We would therefore favour the publication of separate return and volatility figures over a risk-adjusted return figure.

Question 11: What are your views on presenting returns only as an annual geometric average to provide consistency with the DWP's requirement?

We are supportive of this and any efforts to align the requirements of the proposed framework with existing DWP requirements.

Question 12: We welcome views on how you see this developing. Would it be helpful/possible to establish a benchmark or would you prefer to compare cohorts against a market average or against a few selected similar schemes? If so, how would that selection be made?

We think it is extremely difficult to establish meaningful benchmarks that account for both the differences amongst scheme membership and the varied investment strategies pursued by Trustees because of these differences. Accordingly, schemes may be measured against, e.g., reference portfolios or composites that are not tailored to the specific characteristics of scheme members. This may lead Trustees to pursue investment strategies that align with the benchmarks but to the detriment of their members.

The proposal to use Nest as a potential benchmark illustrates the potential issues with benchmarks more generally. Our investment strategy was established after conducting detailed research into our membership and after careful deliberation of how best to serve their needs. This involved accounting for – among other factors – the lower average incomes of Nest members as compared to the broader working population. Whilst Nest's investment strategy has proven successful in meeting our stated objectives, it may not be appropriate for schemes with different member characteristics. Other schemes may thus pursue an investment strategy to mirror Nest's investment performance at the expense of a strategy that would more closely align with its members' needs. This would likely stifle innovation in investment strategy and encourage Trustees to ignore their members' unique characteristics.

In short, using broadly applicable benchmarks would encourage herding toward the strategies and objectives of those benchmarks. Trustees are currently charged with knowing their members and acting in their best interests. We see this flexibility as one of the strengths of the trustee model.

Question 13: Do you think a commercial benchmark is likely to emerge if these data are made publicly available?

[No answer]

Customer service and scheme oversight

Question 14: Do you agree the quality of communication is a relevant factor to consider in VFM assessments?

We agree with the Regulators that communication can improve long-term outcomes, and that this aspect of member services is relevant to value for money. Based on Nest Insight research, effective communication can boost engagement and impact the actions and responses of savers, increasing their confidence and empowering them to make positive decisions. For example, foundational

messages can help people overcome barriers to planning for retirement. These include messages emphasising what savers already have accumulated and highlighting steps to be taken.[2] A separate piece of research found that communications should be positive, plainspoken, plausible, and personalised.[3] Whilst communication is by no means the most significant factor in driving retirement savings adequacy, it can help address some of the knowledge gaps and help consumers build the foundational understanding to engage more.

Question 15: Do you agree administration is a relevant factor that contributes to long-term VFM?

We agree that administration is relevant to VfM. Poor quality administration can cause member detriment. For example, good administration includes the timely and accurate processing of transactions. A breakdown in these processes can lead to member detriment through an inability to access benefits in times of need. Similarly, poor administration in the form of inadequate customer contact services may lead to detriment. A poor member experience in this area could result in frustration and disengagement from the pension scheme, leading to worse outcomes. Scheme administration is an important aspect of member services and should be maintained to a high standard to improve long-term member outcomes.

We would also note that some administrative services lend themselves to quantitative measurement. For instance, as part of its master trust authorisation, Nest currently reports on the times it takes to execute core financial transactions. We also measure service metrics such as waiting times for members contacting the scheme by phone. These and similar metrics could provide a starting point for the Regulators' work in this area.

Question 16: Do you agree the effectiveness of governance is a relevant factor that contributes to long-term VFM?

We agree with the Regulators that effective governance contributes to VfM. Toward that end, having the right people, knowledge, and training is equally important – if not more – as having high quality policies and procedures in place. tPR's Code of Practice sets out the standards expected of trustee boards, highlighting the importance of Trustees understanding their role and making informed and knowledgeable decisions. Trustees should design schemes for the needs of their membership, but requirements for Trustees in terms of knowledge and experience help ensure that good decisions are made. We agree that governance contributes to VfM and would encourage the Regulators to align the governance requirements for Trustees and IGCs. We would note, however, that the flexibility provided by the Trustee model – within the strictures of the governance regulations – is one of the strengths of the current system. We would caution against implementing any regulation that would restrict this flexibility and potential to innovate in the interest of member outcomes.

Question 17: In your opinion, are there any obvious service standards missing from the above list? Please explain how your suggestion contributes to scheme value.

No.

Question 18: Do you agree this is not a role for the regulators at this stage?

We agree that the factors set out in the discussion paper (member communications, administration, and governance) are either wholly or partially qualitative and, in many cases, difficult to measure and therefore compare. For this reason, we agree that it will be difficult for the Regulators to implement and enforce standards at this time. However, we would note that tPR currently plays a similar role in the master trust authorisation process and supervision. We view the Regulators' attempt to describe the qualitative components of value for money as a step in the right direction. Whilst we think that quantitative metrics relating to investment performance and costs and charges comprise a significant

[2] https://www.nestinsight.org.uk/wp-content/uploads/2021/10/Small-steps-to-a-better-future.pdf

[3] https://www.nestinsight.org.uk/wp-content/uploads/2020/11/Beyond-the-defaults.pdf

portion of value for money, there is certainly also value in finding ways to assess the value for money delivered by schemes against the other areas cited in the discussion paper.

Question 19: Would it be helpful to appoint a neutral convenor to develop a service metrics standard? If not, who do you think should create metrics on service in pensions?

At a high level, we support the principle of appointing a neutral convenor as proposed in the discussion paper. We also agree with the underlying rationale for the proposal: that providers and schemes should not be encouraged to compete on customer service above minimum standards. At this early stage, however, there are a number of important questions that must be worked through to ensure that the process results in meaningful standards. For instance:

- How would the convenor be chosen?
- How would its work be funded?
- What process would the convenor follow in establishing service standards?
- Who would be involved in that process?
- What role would the Regulators play in that process?
- How would the minimum standards account for different membership demographics across schemes?

Any further work on this proposal should resolve these and other important questions. We would be happy to work with the Regulators on this proposal and help to explore some of these issues.

Question 20: Do you think that over time independent certification against a standard is worth exploring for benchmarking service metrics? If not, what alternative arrangement would you suggest?

We believe the Regulators' proposal to adopt an independent certification regime for scheme service metrics merits further consideration. We are particularly interested by the intent of the policy proposal and agree that schemes should not be encouraged to compete on service factors above minimum thresholds. Again, however, there would be significant challenges in implementing the proposal. For example, it places significant emphasis on setting the service standards at just the right level to ensure they provide value to members whilst not overburdening schemes. We are concerned that it will be difficult to achieve a set of one-size-fits-all standards that would apply across all types and sizes of schemes.

Costs and charges

Question 21: Should we use the existing administration charges and transaction costs definitions in developing VFM costs and charges metrics?

We support using the existing definitions of administration and transaction costs in developing VfM metrics.

Question 22: Would splitting out the administration charges be a more useful metric? If not, are there other definitions you think would be more appropriate?

We generally support greater disclosure and transparency and welcome the Regulators examining this issue in more detail. However, we would encourage careful consideration of this proposal due to its potential significant impact on the market and the potential consequences of getting it wrong. Industry investment costs can be opaque, and providers may be able to game the disclosure requirements by obscuring charges. In that case, their value would appear comparatively stronger than other schemes. At the extreme, the market forces intended to drive improved value could have the opposite affect: providers could be rewarded for innovation in obscuring charges rather than for deliver value for member. Any proposal must ensure that the information provided on investment management funds is sufficiently accurate and uniformly reported to provide a useful metric.

We do not see these obstacles as reasons not to attempt this work. It should be done, however, with the complexity of the task top of mind.

Question 23: Do you agree we should introduce benchmarks for costs and charges?

We would reiterate our concerns with benchmarking that we outlined in response to Question 12. In short, using benchmarks will likely encourage herding and limit the flexibility afforded Trustees to deliver value to members. We would strongly prefer a regulatory approach focused on the inputs and processes used to arrive at investment decisions.

Data is already available in the public domain on costs and charges via DWP's charges survey, published chair's statements, and IGC reports. Such data is currently being used by consultants and others to benchmark value. We think a regulator-sponsored benchmark is unlikely to be truly comparable and poses risks of driving undesirable behaviours such as herding.

Question 24: What are your views on our suggested options for benchmarking costs and charges? If not these options, what benchmarks should be used?

Again, selecting specific benchmarks for costs and charges highlights the potential issues of benchmarking more broadly. For example, using Nest as a benchmark would be inappropriate for many schemes. As the discussion paper notes, Nest benefits from economies of scale that other schemes cannot match. Additionally, our investment approach was chosen specifically to meet the unique needs of our member population. It is likely inappropriate for most other schemes to adopt this same approach. This would be reflected in costs and charges as well as investment performance. We would therefore urge the Regulators not to take forward work on developing or sponsoring benchmarks.