

DWP Review of the Default Fund Charge Cap and Standardised Cost Disclosure



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 830,000 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 9.3 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 £20,300 per year and nearly half our members are aged under 35 years old.

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

2 Response

Potential changes to transaction costs

Q1. What are the advantages or disadvantages of extending the cover of the charge cap to include some or all transaction costs?

Q2. What would be the impact on scheme member returns/industry if some or all transaction costs were covered by the cap?

Nest welcomes the steps that have been taken to improve the way transaction costs are calculated and disclosed, and we support ongoing scrutiny by Government of the effectiveness of these measures. It is important that schemes are fully transparent about, and closely monitoring, all costs that fall on their members.

On balance, however, we do not think there is sufficient member benefit to be gained from including transaction costs in the charge cap. Whilst transaction costs should be as low as possible, higher costs

¹ Employer and member numbers correct as of 17/08/20, Nest in Numbers; Member earnings and age data correct as of 01/06/2020, quarterly briefing data pack, Scheme MI

do not alter the rationale for investing in certain asset classes, and differing transaction costs should not be used in isolation as a measure of whether a particular asset offers value for money.

Investment managers are required to achieve 'best execution' by minimising transaction costs for a given trade and ultimately, they account for a small part of overall investment costs. Transaction costs for the Nest Retirement Date Funds are between 0.000 and 0.062 per cent, and for other Nest fund choices they are between 0.000 and 0.046 per cent. Including these costs within the charge cap may have the attraction of simplicity but, the adverse consequences could well be greater than the further streamlining of cost disclosure that including them in the charge cap would represent.

For most savers, transaction costs are such a small part of total expenses that their inclusion would be 'lost in the rounding'. At the same time, inclusion of transaction costs in the charge cap would risk introducing several unintended and potentially severe consequences in the form of perverse incentives which could affect investment manager behaviour. Our chief concerns are that the inclusion of transaction costs in the cap could lead to pension schemes/investment managers trading less than may be optimal in order to stay comfortably within a transaction cost budget and avoiding investment in asset classes with higher associated transaction costs.

Explicit transaction costs vary depending on the types of investment. Asset classes such as property incur higher costs due to associated legal, survey and valuation fees and stamp duty. If transaction costs were included within the cap, investment managers may be incentivised to minimise costs by excluding certain asset classes that incur higher transaction costs if those costs place them at risk of exceeding the charge cap, especially when this may happen inadvertently due to the time lag and variability associated with some transaction costs.

As long-term investors we believe there are opportunities for members to benefit from the additional returns available from illiquid assets, such as private credit and infrastructure equity. These are an increasingly important part of Nest's diversification strategy to achieve better risk-adjusted returns for our members. These asset classes are less easily bought or sold and have inherently higher transaction costs so there is a risk that inclusion of transaction costs in the charge cap might impact on our ability to diversify into these asset classes. Many other schemes in the market would face a similar dilemma.

Further, we believe that a cap is unlikely to bring down transaction costs in the way the original charge cap may have brought down investment management charges. The level of transaction costs are set by a global multi-trillion pound market operating at thin margins: UK DC capital on its own does not carry sufficient weight to squeeze these costs lower.

Finally, schemes are already taking measures to minimise implicit transaction costs. Nest has, in effect, created an internal market between Nest Retirement Date Funds. Funds which are reducing exposure to certain asset classes in accordance with their investment strategy and asset mix can transfer those investments to funds seeking to increase their exposure. More widely, the agreed industry measure for reporting implicit transaction costs has been in effect for a short time. We would expect to see more trend data on this before any changes are made to the way transaction costs are assessed.

Q3. Should there be a combined transaction cost and charge cap, or should these be separate?

We do not think there is currently a need for either a combined cap or a separate cap for transaction costs. Fund managers have a responsibility to achieve 'best execution', and we believe this is effective at keeping transaction costs at reasonable levels and, in absolute terms, very low. Capping may reduce the volume of transactions, but we do not believe there is evidence of unnecessary churn in modern DC plans.

Ultimately, having a separate transaction cap would raise the risk of unintended consequences around disincentivising investment in certain asset classes. Investment managers may make the rational decision to select funds with fewer and lower transaction costs which, in turn, are associated with lower returns. Assets with an illiquidity premium risk being excluded, which would not be in the long-term interests of savers. This would also be at odds with several of the shared objectives we have with the

Government on climate change, investing in infrastructure, and on DC schemes having a bigger role in illiquid investments.

Q4. Who should be responsible for complying with a transaction cost cap?

We do not think the introduction of a transaction charge cap is necessary at the moment. Nevertheless, we welcome continued monitoring by DWP and regulators of the effectiveness of measures designed to improve the disclosure of transaction costs.

The level of the charge cap

Q5. If we lowered the cap, what would be the impact on (a) scheme member outcomes (b) industry?

Average charges for schemes operating at scale in the automatic enrolment market are now well below the 75bps level of the charge cap. Action by Government over the last 20 years has helped bring DC charges down from a reduction in yield equivalent to over 200bps – and it is important that we keep considering how through regulation we can secure the gains we have made in bringing charges down on behalf of members.

A good quality scheme - with a well-diversified investment strategy of traditional DC assets - can be funded with charges well below 50bps. For schemes with higher member turnover, lower-earning members and minimum contribution levels, the cost of funding all the components of a good scheme are necessarily higher. Nevertheless, well-governed schemes with diversified investments, are demonstrating that it is possible to deliver good returns and a high-quality member experience whilst charging well below the charge cap. We see little reason, therefore, for any scheme to be charging at or very close to the charge cap.

Lowering the charge cap is not without risk: schemes could respond with lower quality and cheaper solutions for members. In terms of investment, this could take the form of less diversification. More likely, member engagement and communications could become more compliance-led with less support to aid decision-making. Narrowing of profit margins could also lead to unintended consequences for members, as some schemes may seek to recoup lost revenue through fees on small or deferred pots, for example – so the issue of flat fees needs to be tackled at the same time, as this consultation acknowledges.

However, these risks would apply to the members of a minority of smaller schemes, and we believe are outweighed by the risks to the broader DC membership of allowing charges to remain higher than they need to for a prolonged period of time.

We would therefore support Government setting out a timetable to lower the cap below 75bps. We do not set out here how far or how fast the Government should seek to lower the cap, but would be very happy to work with the Government and other schemes to consider this in more detail. Clearly, it would be important to consider the impact of the current economic climate as part of these considerations.

Q6. How have investment approaches altered as a result of the introduction of the cap? What changes have there been in asset allocation, management style (active, passive, factor based)?

It is difficult to identify the effect of the cap on investment approaches in isolation from broader market conditions, but as the auto enrolment DC market matures schemes are becoming more effective at negotiating costs down. As one of the largest master trusts, Nest is able to leverage our scale and strategic importance to negotiate good deals with asset managers. These efficiencies may be harder for smaller schemes to achieve.

Q7. Have schemes changed administrator or asset manager in response to the cap?

Nest's combined charge is broadly equivalent to 0.5 per cent AMC and has remained at the same low level since inception. We select both our scheme administrator and our asset managers through the lens of value for money, rather than in direct response to the charge cap, due to our ability to operate well clear of it. Our approach has helped to bring down costs across the market, including levelling up access to well-diversified investment strategies at a low cost to members, where access has traditionally only been available to higher earners.

Often the biggest part of the pensions "value chain" is scheme administration rather than investment costs, so downward pressure on the cap is likely to be borne by the former. However, clearly any change to scheme administration is a huge undertaking, in terms of time, cost and operational risk.

Q8. What links have you found between cost and performance?

Nest is a vocal advocate for low cost index-based investing in certain markets, such as global listed equity. Nevertheless, some asset classes objectively cost more than others, and at an aggregate portfolio level, members' risk-adjusted returns are enhanced by having exposure to those asset classes. DC schemes should have the latitude to spend some basis points on accessing certain systematic risk premia (such as illiquidity, for example), but at the same time be cautioned against the temptation of spending members' money where there is limited evidence of a positive relationship between cost and performance.

Q9. How much notice should be given for any reduction in the cap?

The charge cap is just one tool to support an industry that best serves its members. Establishing a timetable for further reduction feels appropriate, providing regulations to protect members from the unintended consequences of firms making their commercial return elsewhere (leavers, small pots etc) are also introduced.

The wider regulatory response must not only protect members from those unintended consequences, but also support the drive towards greater scale, quality and value for money. On this latter point, we strongly welcome further regulatory clarity from TPR on their planned work to establish an industry standard on what constitutes value for money.

Use of combination charges

Q10. Do you agree with the suggestion to incorporate new conditions into flat fee structures? If not, what other ideas do you have to address the effect flat fees can have on small dormant/deferred pots?

Charging structures with a flat-fee element run the risk of eroding small pension pots to zero. Nest feels strongly that flat fees do not have a place in a pensions market which is designed to help low and moderate earners to save for retirement. We support proposals to protect savers who are at risk of having their savings eroded by flat fees - including the idea of putting bounds on fees by pot size.

However, while it is very important to tackle this issue it is important to consider the impact that it would have on the economics of some pension schemes, and the healthy functioning of the automatic enrolment market. As pension coverage has increased so has the number of small pots and changes to fee structures would in some cases compound the economic problem that small pots pose to schemes.

Any limits imposed on flat fees should strike the right balance between protecting members and not causing undue disruption to the market at what is a very difficult time. In the meantime, we need an industry and government-led resolution to the problem of the proliferation of small deferred pots, which do not yield enough charges for some schemes to cover their direct running costs.

If pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation is required. We intend to undertake a piece of analysis on small pots at Nest and are keen to work with Government and industry colleagues on finding practical, member-centric solutions to the problem.

Q11. Should any approach to limit flat fees apply for all scheme members with a pot below certain sizes, or only for deferred scheme members? At what level should the limit apply in each case?

We have not developed a position on these questions.

Q12. Are you aware of any issues that would make it difficult to implement this kind of mechanism to limit flat fees, in particular, in relation to the broader issues around the desirability of consolidating small dormant/deferred pots?

Q13. What would be the impact on scheme members/industry?

Limiting the use of flat fees is critical to preventing savers' pots from being entirely eroded by charges. No one should find themselves in the position of being automatically enrolled, in many cases unknowingly, and finding that their hard-earned savings have been reduced to nothing. People who have been auto enrolled are often lower earners who may accrue a number of small deferred pots, all of which are vulnerable to complete erosion in a flat fee scheme. Limiting flat fees is the best way of offering those members a degree of protection without them having to take any decisions or actions themselves.

The wider impact on industry is complicated. Introducing such a change may put some schemes in a difficult economic position, particularly when they have just invested in Master Trust Authorisation and with the economic impact of Covid bearing down.

Nest fully supports a well-functioning master trust market, but we feel strongly that damage caused by flat fees to the pots of auto enrolled savers should be minimised. This approach would go some way to resolving that. At the same time, we need action to address the proliferation of deferred small pots that is driving cost into the industry across the board.

Standardised cost disclosure templates

Q14. Is legislative intervention required to support the uptake of the CTI templates?

Q15. How easy is it to request cost information from asset managers?

The majority of managers are providing the required information to trustees. Some asset managers took several months to adapt their reporting process to the CTI templates, but we are not aware of any barriers that have been encountered. We do not believe that uptake of the templates needs to be mandated through legislation.

Q16. Do you believe that scheme members and recognised trade unions should have the right to request the information provided on the CTI template, and that a requirement to disclose this on request is proportionate?

Nest's aggregate transaction costs are disclosed in the Scheme Annual Report and Accounts. Disclosing this information to interested parties at a more granular level would need to be measured against the commercial sensitivity of the arrangements between a scheme and any individual service provider.

Q17. Should DB schemes be required to adhere to the same standards?

We do not have a view on the application to DB schemes.

Q18. What are the barriers to using the information obtained when making decisions?

The information disclosed on the CTI template is just one part of managing the relationship between pension schemes, asset managers and investment consultants. As CTI disclosures are built up over time, they will offer a richer source of data for evaluation and meaningful comparison.