

Quality standards in workplace defined contribution schemes

A call for evidence response

Introduction

We are pleased to have the opportunity to respond to this call for evidence. As a new provider designed for scale we have an obvious interest in the future of the workplace pension market and are pleased that the Department for Work and Pensions (DWP) is taking active steps to promote quality in the market. The workplace pensions market faces some unique challenges that stem from its unusual structure, aspects of which risk creating diminished outcomes for pension savers. We support the position of the government in its assertion that it has a continued role in supporting customers in an automatic enrolment environment and the work of The Pensions Regulator (TPR) in developing a code for DC schemes.

We believe that the DWP has a good opportunity to set minimum quality standards now and also to set out a long-term direction for the pensions market to ensure that it ultimately works in the interests of consumers. This should amount over time to the substantive change we believe the market needs without disrupting the implementation of automatic enrolment.

Our view of the market

As a new participant in the market our views are at an early stage of development. Nevertheless, we feel that it's worth making some observations about how we see the current operation of the market. These comments underpin what we say later about the quality standards suggested in the call for evidence document.

We feel that competition doesn't always drive better outcomes for consumers. This is for the following three reasons:

- High information asymmetries between the end customer - the member - and advisors, which contributes to customer or member disengagement.
 - Principal agent problems where the entirely legitimate concerns of those making the choice of scheme - the employer - can differ from the concerns of the end customer - the member. Many employers are treating automatic enrolment as a compliance challenge and this is affecting what they value in a scheme. NEST Corporation's experience and research point towards the quality of the investment approach, for instance, being much less important to employers at scheme selection than ease of administration. This is of in spite of the investment approach being the biggest single product feature that drives the outcome a saver can expect in retirement. In short there are further legitimate concerns at play beyond simply what is best for the end customer.
 - Member disengagement, which is linked strongly to the above and is partially a product of those two factors along with consumer disinterest.
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These issues potentially create a misalignment between the incentives created by competition and the needs of the end customer. The primary issue here is that consumer involvement and hence demand is simply too weak to drive the market in the desired direction. In a well-functioning market, we would expect much closer alignment between competition and the customer interest. The main question underpinning this call for evidence is how to adjust the framework of the market in order to alleviate potential problems caused by these issues.

To our mind, this framework consists of:

- (i) competition between providers
- (ii) regulation
- (iii) standards imposed by government
- (iv) governance.

So while the third item is the focus of the response, we also try to consider how this interrelates with other aspects of the market framework. Our feeling is that the government should only set standards when other aspects of the framework are not working as they should.

Bearing in mind this approach we conclude in our response that the government should set minimum quality standards along the lines of those suggested in the consultation document. This is an opportunity to set the direction of travel and shift the market from its current state into one more directly focused on serving the end customer.

Governance

Our view of the role of governance in workplace pension schemes is heavily influenced by our view of the market. In our view, the purpose of governance is not just to ensure the effective running of a scheme, it is also there to compensate for any misalignment between the incentives created by the market and the needs of the member or end customer.

As we noted above the market framework is composed of four sets of things: competition, regulation, standard setting and governance. The latter two become more important - potentially much more important - when competition is too weak to deliver the desired result. We think the last one - governance - becomes much more important in areas that are difficult to specify or to regulate effectively. Typically, these will be those most dependent upon judgement.

1) What are the essential features of good governance?

We think that the DWP has identified the right issues. They are:

- an alignment of interests between people running the scheme and members of the scheme so that decisions are taken in the interest of the members; and
- that people running the scheme have the skills and knowledge to be able to act in the interests of scheme members.

Alignment of interests

The Department is right to single out alignment of interests as the most important element of the governance debate. While this is much easier to achieve in a trust-based scheme, as the bulk of the legal framework is already in place, there is still much to be done even in these schemes. The emergence of large-scale master trusts in response to automatic enrolment potentially creates further complexity as fiduciary duties are only a partial guide to the effective running of a master trust.

We feel that it is important that all workplace schemes, whether contract or trust-based, have some form of provider or employer-based governance committee or structure. As a provider configured, in part, to serve smaller and medium-sized employers we believe that employer-level governance should be a choice for the employer rather than something that is mandated. As such, we have a bias towards governance at the provider level.

Master trusts, fiduciary duty and commercial issues

The market is currently seeing the emergence of a number of multi-employer 'master trusts'. Master trusts offer one possible route to developing large, well governed pension schemes. That said, we have some concerns about how this new form of provider is developing in the market.

Trust-based organisations operating in competitive markets are comparatively rare and there is relatively little legal precedent shaping how they should be run. Fiduciary duties are much better understood in respect of investment and the bulk of case law pertains to the responsibilities of the trustee as custodian of the monies with which they have been entrusted.

But running a master trust is not just about the investment power. Trustees have to decide what sort of business practices will be acceptable to them in making themselves attractive to employers and advisers. Some things that seem on the face of it to be bad indeed for the member – for example active member discounts, short service refunds and member-facing consultancy charging – have been seen by some as being compatible with the fiduciary duties of a scheme trustee in this context. This suggests that there may be limits to the effectiveness of the fiduciary duty in the master trust context in providing protection for the consumer, as illustrated by the recent announcement by government that they intended to ban consultancy charging for all automatic enrolment schemes.

We feel that there is a need to connect these issues with the review of fiduciary duty currently being undertaken by the Law Commission. This is focused appropriately on consolidating what the fiduciary duty currently is. There is likely a need for a subsequent piece of work examining the limits of fiduciary duty and how it might need to evolve in the light of the changing nature of provision in response to automatic enrolment.

Employer-level governance

In general we do not feel that encouraging governance structures at the employer level is the right approach. Where these exist and are effective they should be preserved and not driven out by alternative arrangements. But governance at the employer level has significant drawbacks.

- The member will eventually leave the employer. Some employers have favoured active members over deferred members in their current and previous pension arrangements. We do not feel that this is conducive to good member outcomes in the context of automatic enrolment. Provider level governance is more likely to result in equal treatment of members.
- An employer's lifespan may be shorter than the duration of a member's working life.
- Only the largest employers are likely to be able to effectively govern the default fund of a workplace DC pension scheme. Other aspects may be run effectively but investment management, for example, requires time, money and skills.

Competence of governing body

We think that competence is not simply a matter of understanding pensions, trust and commercial law. Governing a scheme, especially a large scheme, requires other skills that may be in shorter supply than pension-specific knowledge. In particular with the governance of a master trust we are now looking at a skillset that looks much more like a combination of the skills of a trustee and also the skills of a non-executive director. This is because the scheme has the characteristics of a pension scheme but also, increasingly, some of the characteristics of a business. This includes the running of large-scale administration functions and the communication with thousands of members.

With that in mind, we feel that a broader discussion of board competence is merited. There is a deserved focus on trustee qualifications but we feel that qualifications are only part of the picture. The content of appropriate qualifications might be as good a place to start as the requirement for qualifications themselves.

Involving members in the governance of the scheme

It is well documented that most people have little engagement with their pension and little knowledge of how pensions function. Often people are simply not interested. This makes direct member involvement difficult for a scheme like NEST that has no direct tie to a single employer.

We have two main ways of involving members in the governance of NEST and feeding members' views into the configuration of the product. The first is our Members' Panel, which we have a statutory responsibility to consult. The intention is that the Members' Panel is able to act as an informed advocate for the expectations of members as we further develop the NEST scheme.

The second route is research. As we discuss below with reference to the investment approach, we have made extensive use of qualitative and quantitative research in the development of the NEST scheme. This approach has allowed us to take complex decisions, for example, about risk appetite, on some sort of evidential basis. It has also meant that we have an un-mediated, or only lightly mediated view of what the target group for automatic enrolment actually wants from a workplace pension scheme. As others might find this interesting and useful, we have made much of this available publicly on our website.

2) How does the presence of these features affect the decisions taken about running a pension scheme?

The central issue is what 'aligned interests' mean in practice. As we noted earlier, the concept of fiduciary duty is much more developed in relation to investment and the notion of stewardship of resources. We have included a worked example below that shows competing priorities that emerged during the construction of the NEST investment strategy. We feel this is a useful example as it shows how the Trustee and NEST Corporation staff had to decide between several desirable but mutually exclusive things in order to deliver the investment approach.

Putting the customer first: competing objectives in investment

The intention here is to look at a case that shows the tensions that arose as we developed the NEST investment approach. We think this is an interesting case as it shows some of the things we had to trade off as we developed the investment approach. Broadly we were faced with a choice between following the behavioural economics evidence base, our consultation findings and our own market research or producing something that looked more conventional. This was a direct trade-off between the member interest, as reflected in the evidence base, and concerns about how the scheme would be received if it departed too far from received wisdom.

Our investment approach has a number of features that are uncommon in the pensions market but are rooted in research commissioned by NEST Corporation. Using research to support the investment strategy is not simply a matter of commissioning research and then implementing the findings. Rather, it is important to treat research as one factor to be balanced with and against expert judgement, legal advice and other inputs into the decision-making process.

NEST offers a focused range of funds. These are named such that the impact of the fund on the member's money is clear or such that the intention of the fund is obvious. They are not named for marketing purposes or to appear attractive to an investor. Market research shows that large fund ranges are popular and associated with product quality, not least among intermediaries advising employers. We believe because of scale and resource dedicated to it, for most people most of the time their financial interests are best served by selecting, or remaining with the default strategy.

We also do not expect most people to choose a fund other than the NEST default fund, partly as we do not think that they will be able to afford financial advice or be inclined to take it if they could afford it.

Adding more funds to the menu would make the product more appealing in some quarters but it would be likely to be more expensive to construct. Given that we do not think that people would take advantage of a wider range of funds, we thought that this approach would risk making the product more expensive for members in return for little additional benefit. We also felt, following evidence from the behavioural economics literature that larger fund sets were likely to decrease the likelihood of individuals exercising a choice. In evaluating the number of funds to offer, NEST's Trustee considered the interest to members lay with a restricted fund range that met members' needs but might have been less attractive to employers and intermediaries than a broader approach. As such, this is the inverse of the usual commercial decision: the product is harder to 'market' but we believe that it is better, overall, for the membership.

Quality of governance really matters, therefore, where the choice is between two things that might be desirable for an organisation but where one of those things is more in line with the interests of members than the other.

3) How many schemes currently exhibit these features?

We can only comment on our own scheme.

4) What are the barriers to exhibiting these features?

We feel that there are several potential barriers to exhibiting the features we have described above.

The structure of the product and the legal framework is potentially important, given that we anticipate the customer being relatively inert. Those governing the scheme need to be able to change aspects of the product without the customer's explicit consent.

Schemes also need to be able to show how they can balance competing interests. This may be more acute outside of the trust-based sector, where the presence of shareholders may complicate matters. Nevertheless, we believe that a degree of interest alignment outside of the trust-based sector is desirable.

Schemes must be able to show how they can balance competing priorities and, generally, resolve these in the interests of the membership. We outlined some of the difficulties associated with this in our investment example earlier.

Schemes must be able to manage commercial pressures appropriately. It is important that trustees are able to recognise that some business practices, for example consultancy charging, may cause serious member detriment and that the benefits they bring to a scheme do not justify their adoption.

Governance is also resource intensive. Trustees need decision-making support and access to the right research, information and analysis. The precise requirements will vary from scheme to scheme but the resourcing requirements will typically be much greater for larger schemes.

5) Given what we say about what good governance should achieve, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

- *All schemes must be overseen by a governance body with a duty to act in members' interests, which meets at least every six months to consider the running of the scheme*

We think that this would be a welcome advance, subject to our earlier comments. We do not feel, though that meeting every six months is sufficient to deliver good governance, especially in a master trust such as NEST. One solution here would be for the frequency of meetings to correspond to scheme size.

- *The governance body must be able to freely exercise its duty to act in members' interests and must be able to explain how any conflicts of interest are handled*

Again, subject to our earlier comments we feel that this would be an important and welcome advance. We note, though, that the importation of some governance structures into the contract-based sector may be problematic. This may require the creation of a different standard for the alignment of interests that falls short of fiduciary duty, or alternatively governance committees taking a largely advisory role.

- *For multi-employer schemes, both occupational and group personal, a majority of the individuals on the governance body must be independent*

We feel this is a sensible suggestion and that DWP could potentially be bolder and suggest a higher proportion of independent individuals - perhaps as high as 80 per cent. We note that other parties including TPR have expressed concern at governance arrangements common in the master trust sector. We feel that having a majority of independent trustees running a master trust will help deal with the conflicts of interest that are possible with some master trust structures. We note though, that trustees are only one part of the issue and would point out that where powers lie is as important as the identity of trustees.

- *25% of the membership of the governance body must have an appropriate professional qualification*

We feel that a broader conversation about competence is required that ranges beyond qualifications, as we have set out earlier. Increasingly, in the governance of master trusts, we feel that trustees need to have a combination of the skills of a trustee and also the ability to govern a business at scale.

¹GfK Financial Research (2012) 'Exploring Fund Choice' commissioned by NEST Corporation (unpublished).

²See for instance, Iyengar, S S, Huberman, G, Jiang, W, (2004). 'How much choice is too much: determinants of individual contributions in 401K retirement plans', from Mitchell, O S, Utkus, S (eds.), Pension Design and Structure: New Lessons from Behavioral Finance. Oxford University Press, Oxford, pp. 83–95.

Investment – default options

6) The default option guidance covers the key steps in governing, designing, reviewing and communicating the default option. Does this cover the most important steps or are there others missing?

The broad structure of designing, reviewing and communicating the default strategy is in our view the correct one. However we have concerns as to whether the sub-components contained within these high-level headings are descriptive or prescriptive enough to encourage the quality in DC investment provision that the government is seeking. For example in requiring schemes to provide a default strategy suitable for the majority of workers who are likely to use it, there is little explanation of what is expected when assessing suitability, and what good or best practice looks like when constructing an understanding of the investment risks beneficiaries need, want and are able to take. Similarly there is little narrative as to what an understanding of these characteristics should translate to in terms of suitable investment design features. For example if a thorough analysis of a scheme membership revealed a majority of high-earning, high-saving individuals mainly in their twenties and thirties, with high risk capacity and appetite, then appropriate default design responses are likely to be to pursue strategies that expose individuals to significant levels of risk. We would expect this rationale to be set out by pension schemes and pension providers, but have seen little evidence that this is happening.

Judging from the DC default strategies we have observed, it's not clear whether suitable analysis is being carried out, and where this analysis has been carried out, that it's being translated into suitable investment strategy responses.

NEST conducted an extensive research programme into its likely membership prior to setting its investment strategy, consisting of primary research into risk appetite, loss aversion, income breakdown, existing savings behaviour, work patterns, age profiles and outcome expectations. In addition we carried out further research into cultural drivers for saving within minority groups in order to assess what additional provision would be required beyond the default fund.

This research led to a number of innovations that we believe make DC saving more suitable for NEST's target market, examples of which are:

- Investment return objectives based on generating real return rather than focusing on outperformance of traditional benchmarks (such as the FTSE 100).
- A dynamic approach to risk management that incorporates genuine diversification across asset classes, geography and sector.
- Yearly target date funds – to allow greater efficiency and flexibility in managing risk throughout a member's savings career.
- Phased approach to investing with different risk and return objectives for different stages of a savings career.
- Objectives designed to reduce the impact of 'path dependency' so that individuals contributing at different times in economic cycles are less likely to see widely divergent outcomes.
- Objectives aimed at mitigating the impact of catastrophic market loss.

For smaller schemes, such an extensive research programme would not be appropriate, but smaller schemes are likely to have a far closer relationship with scheme members and their employers. It should be possible for them to build up a rich understanding of member demographics and needs in order to design suitable investment solutions.

For larger multi-employer schemes we believe far more effort could be given to developing an understanding of scheme membership characteristics. This information could be publicly disclosed in order to allow scheme members and employers to assess whether they fit the proxy majority-member descriptions for which the default fund or funds have been designed.

NEST's research base is publicly available and has benefitted from the input and oversight of NEST's Members' Panel. While we recognise the level of scrutiny and verification may not be appropriate for all DC automatic enrolment schemes we believe the current differences in evidence-based investing are unlikely to provide the reassurance the government is looking for in terms of quality standards. Our impression is that the current guidance, while asking the right questions, does not provide sufficient imperative for the design of strategies that are truly suitable for the 'new majority' of pension savers.

One such example can be seen in Towers Watson's 2012 FTSE 100 Defined Contribution Survey. Only 21 per cent of companies reported performing a segmentation exercise of their scheme membership before determining the appropriate default strategy. It is perhaps not surprising then, that 78 per cent of default strategies report an entirely equity-based strategy for the majority of an individual's savings career with 7 per cent of schemes invested in UK equities only. NEST's experience, based on extensive consultation, international peer comparison, in-house expertise and the latest academic thinking would question the suitability of an investment strategy that relied on a single asset class. We would question whether the spirit of the default guidance is being applied, if nearly three quarters of DC schemes provided by some of the largest companies in the UK can place millions of automatically enrolled workers into a strategy with little diversification and little risk management (until a member reaches the last five or 10 years of their lives).

As with any DC pension scheme, individuals in the default option will be exposed to investment and other risks. Thought should be given to managing risk to achieve the best outcome for members.

- *The default option's investment strategy should manage these risks through the appropriate and diversified allocation of assets. Risk should not be considered in isolation.*
- *The investment strategy should reflect the overall objective of the default option and the balance between risk and the potential for growth.*
- *The investment strategy should take into account, on reasonable grounds, the retirement profile of members (i.e. number of years from retirement age).*

The default guidance from the DWP quoted above emphasises the importance of diversification, risk management and suitable objectives. We agree wholeheartedly with these principles and have fully implemented them in NEST's default strategy and in three of our five fund-choice options. Data from the same survey suggests that only 22 per cent of large DC funds are pursuing a multi-asset strategy. There is no information about additional risk management, the level of diversification and whether risk or asset allocation is being managed actively in relation to market and economic conditions. We have, however, seen a tendency that funds billed as 'balanced' or 'diversified growth' tend to remain heavily dominated by equities with often 80-90 per cent allocation. The remaining 10-20 per cent tends to be a mixture of bonds and property. It could be questioned whether a strategy so dominated by a single asset class justifies the terms 'balanced' or 'diversified'.

When it comes to communicating the performance of default strategies as set out in the guidance we again support the principle but have concerns about the general implementation. Of most concern is the ongoing obsession with short-term returns. We are frequently asked for data on the performance of our default strategy on the basis of three month or yearly returns. In light of the Kay review, we believe this is an unhelpful approach to assessing performance and the relative merits of different default strategies. We would prefer to see performance measured on what are in our view more relevant factors such as risk-adjusted return, probability of achieving objectives and the impact of tail events on portfolios. We believe this would give trustees, employers, and if correctly communicated, members, a far better assessment of a default strategy's performance.

We believe such an approach would start to unpack some of the challenges that DC members find in understanding, for example, why the reported performance figures say one thing yet their own pot has performed in a seemingly different way. Such an approach could begin to deal with the confusion many new DC members feel when presented with projections that suggest a spurious degree of accuracy juxtaposed with a message suggesting an individual could get less than they have contributed. Our research into improving communications about risk and investment suggest that what members want is greater focus on improving the certainty of expected outcomes, clearer descriptions of what happens to their money and more assurance that saving is not a gamble but a sensible course of action.

Our experience of how default strategies have been communicated in the past, and in particular how projections have been determined, is that they rely on the use of arguably optimistic numbers of likely returns and the assumption that these will deliver for most people most of the time. This is a particular concern with equity-only strategies because of the significant impact of path dependency. In effect, for whole cohorts of savers their final outcome could be significantly determined by the timing of their contributions rather than the size and frequency of those contributions. It is our belief that good practice when communicating default strategy performance or projections of likely outcomes should include the risk taken to achieve that strategy and the probability of success for different cohorts. Currently an all-equity strategy would carry an expected return of 7 per cent. Nothing would be said about the asset class carrying an expected volatility around the mean of 22 per cent, nor that continual contributions for 20 years still carry a 1 in 5 chance of getting less at the end than the amount contributed. We think these kinds of numbers are as - if not more - important than simple return expectations, particularly when considering the levels of investment experience and capability of the millions of newly enrolled members.

7) How far is this guidance followed and is it followed by all schemes (e.g. older schemes)?

We don't have much evidence other than that provided by benefit consultant surveys. This evidence suggests that to a certain extent lip service is being paid to the guidance but the evidence of existing default schemes suggest that many have a different understanding of what terms like diversification, suitability and risk-appropriate mean. The following quote and bullets are taken from Hymans Robertson's 2012 report: *The state of DC in 2012: why it needs to change and how.*

The pension scheme has become marginalised and is wrongly being treated as another cash benefit. Company directors clearly see their DC scheme as just another part of the benefits jigsaw, rather than a vital cog. Both employers and employees now think of their DC pension simply as a monetary contribution within their overall benefits package, rather than a specific benefit designed for retirement. Based on this belief, it is no surprise that the planning and goal setting that is needed to make a DC scheme a success is being neglected.

If this attitude is the case, then it partly explains why DC pensions have failed to achieve good outcomes to date and therefore failed to capture employee or employers' attention – apathy has set in. This needs to be addressed, both to make DC schemes worthwhile for their members, but also to make the investment in them worthwhile for company boards.

How and why companies construct their DC schemes

- *The goals and objectives of companies' pension schemes, when they are considered, are largely set by the trustees and/or a governance committee.*
- *Over a tenth of directors (13%) say their DC schemes have no formal objectives set.*
- *There is a mixed picture on how companies set their investment objectives for DC default funds.*
- *Over half of directors (59%) say their fund has been reviewed within the last two years.*
- *However, the remainder either say the default fund is reviewed less often, that they're unaware of how often this happens or that they simply don't know.*
- *When setting their default investment fund, only 31% of companies say that they take into account the target income in retirement for their scheme members.*
- *The remainder either set this purely to 'maximise returns for members' (25%); set it in line with their pension provider's default option (22%); or simply don't know whether they take this key consideration into account or not.*

8) What are the barriers to following the guidance?

The main barriers are twofold in our view. Firstly, lack of trustee and employer engagement in the importance of investment strategies for DC. We suspect that many trustees who continue to run DB schemes, even when closed to new accruals, spend the majority of their time on dealing with the management of DB liabilities. In terms of assets under management and impact on sponsoring employers it is understandable why this is seen as the more pressing challenge. We also suspect that there is a lack of experience or expertise for many smaller schemes when it comes to strategy construction or provider selection. We would also suggest there is perhaps an overreliance on investment advisors, whose interests may not always naturally be aligned with members. We have certainly seen evidence of herding behaviour where advisers are recommending very similar approaches. Until recently, there has appeared to be little in the way of innovation when designing new DC provision. For example we find it difficult to explain the predominance of very high or all-equity strategies in company schemes, despite more than 60 years of modern portfolio theory that advocates the importance of diversification.

Reasons why this may be the case are likely to be numerous. One is a belief that only the historic higher returns of equity will mitigate poor retirement outcomes in the light of lower contribution rates than were present in DB schemes. This approach has not been helped by the allowance of high projected returns in communications material such as SMPI or 'point of sale' calculations. We are pleased that the FRC and the FCA have made moves to address the use of such optimistic return figures in their recent revision of assumptions to be used when calculating potential outcomes.

We are also aware that traditional views of setting default investment strategies started from the concept of the unknowability of total asset wealth. The hypothesis is that individuals may have many different sources of asset wealth beyond their pension, for example many may own their own homes and have other savings vehicles such as ISAs or premium bonds. All will have their human capital potential in the shape of future wages. The rationale follows that to construct an efficient portfolio all sources of risk and return should be factored in and not just the asset allocation of the pension investment strategy. Consultants and scheme providers have argued in the past that because this is unknowable at the individual level - and default funds are aimed at the majority - a scheme should assume all individuals are well diversified in other parts of their lives. This assumption allows all-equity solutions to be seen as a further diversifier with the added bonus that equity has historically provided some of the highest returns available. We believe this thinking is muddled on two counts.

First, pension saving shouldn't be seen as just another part of a wealth portfolio but should be seen as separate from other assets. At its simplest if an individual owns a property they still need to live in it in retirement. Secondly, human capital has been traditionally seen as bond-like in nature. An individual receives a steady stream of income that gradually increases throughout a working life. The bond-like nature of human capital offers a good diversifier for a high equity strategy. We would suggest that this is too simplistic and what is likely to happen in automatic enrolment is the stream of income arriving into a pension scheme is likely to be more equity like in its volatility, with many people having breaks in contribution, or regular change of employer and scheme provider. We suggest that this model of total wealth diversification, which may or may not have been appropriate in the past, no longer reflects the reality for the millions of soon to be automatically enrolled individuals.

We discussed earlier the structure of the market and the principal agent issues that we think are present at the point of scheme selection. We think that this creates a potential second barrier to the implementation of the guidance. If the interests of providers, advisers and beneficiaries are not in alignment then products that providers and advisers consider optimal are likely to be more prevalent than those that may better suit the member better.

9) Given what we say about how default options should be designed and reviewed, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

The suggested approaches seem appropriate. The missing element is the concept of policing, redress or sanction if schemes, advisers or employers are demonstrably shown not to be meeting these minimum guarantees.

Approaches (from DWP):

Approaches to legislative minimum standards for default options could include:

- *Default options are designed in the interests of members, with a clear statement of aims, objective and structure, and how these are appropriate for the membership.*
- *The characteristics and net performance of the default option are regularly reviewed to ensure alignment with the interests of members, and action is taken to make any necessary changes.*

Administration and record keeping

In general, we feel that there is sufficient legislation in this area but that it is not always applied consistently. We would, though, be able to comply with most of the approaches set out in the document. We are concerned about the proposals in respect of common data. It is difficult for multi-employer schemes to ensure total accuracy of common data. We do not believe that people will routinely inform the scheme of changes of address or the like. Schemes can quickly run out of ways of finding missing data at a reasonable cost, meaning that we believe that this responsibility should be subject to a fiduciary duty test rather than simply being imposed.

10) Which stages of administration and record keeping are so critical to get right, in terms of a member's final pension pot, that they should be set in legislation?

For defined contribution pension schemes, we believe that all stages of administration are critical in terms of their effect on the member's final pension pot. The following distinct stages of administration can be identified.

- Pre-enrolment – The employer must establish a payment schedule with a provider to detail the level of contributions that will be paid, and the dates by which those contributions will be paid. Failure to carry this out properly will mean that the provider is unable to properly monitor contributions and this may have an impact on final pension pot size.

- For enrolment and after enrolment It is essential that the employer provides sufficient information to enable the correct administration of the scheme. In terms of member outcomes, the correct date of birth, name and contact details are key in order to establish the correct retirement age, to establish identity at the point that benefits are taken and to communicate with the member throughout their service. In terms of the information that a provider or trustee should provide to members at enrolment, and throughout their time saving in the scheme, this is currently prescribed by the disclosure regulations . However, research suggests that members do not engage with or take action in respect of these communications. This results in member detriment because their money – through member charges – is being used to produce and send communications that they do not want or engage with. The legal framework should arguably therefore be much less prescriptive in this area. A principles-based framework would allow trustees and providers to develop a holistic communication strategy based on, for example, research insights about which points in their life members are most likely to engage with communications from their scheme, and what type of information they want to receive and how they want to receive it. This would align with trustees' fiduciary duty to act in members' interests and with the policy of automatic enrolment which is based on the insight that individuals don't engage with pensions.
- Decumulation Trustees and providers need to make sure that members are in possession of all of the information on their fund required to enable them or their advisers to make an informed decision on their retirement benefits. However, again rather than be prescriptive here it may be better to allow trustees, acting in members' interests to determine what information needs to be sent, when and how, using insights and evidence to come to their decision within a principles-based legal framework. Providers also need to ensure that the member information that they hold at this time is correct and complete.

³ The Occupational Pension Schemes (Disclosure of Information) Regulations 1996 and equivalent regulations for personal and stakeholder pension schemes.

⁴ See for example the following research into annual benefit statements and statutory money purchase illustrations – which the disclosure regulations require schemes to send annually to members - carried out by the FSA and the ABI: FSA (2004) 'Inflation and pension savings: understanding the presentation of Statutory Money Purchase Illustrations in Pension Statements' and ABI (2006/6) Review of Yearly Statements: making information work for customers'.

11) How far are these stages completed accurately and by how many schemes?

There are already pension law regulations in place that:

- require an employer to establish a payment schedule and properly assess their workforce (Pensions Act 1995, Occupational Pensions (Scheme Administration) Regulations 1996, Pensions Act 2004)
- require complete and accurate data to be provided at enrolment in the majority of cases (Pensions Act 2008, Occupational and Personal Pension Schemes (Automatic Enrolment) Regulation 2010, Data Protection Act 1998)
- require providers to communicate pertinent information to members (Pensions Act 1995, Occupational Pensions (Disclosure of Information) Regulations 1996, Pensions Act 2008, Occupational and Personal Pension Schemes (Automatic Enrolment) Regulation 2010).

There is also guidance setting out the steps providers need to take to ensure that records remain accurate and complete through the member's service (TPR Regulatory Guidance – Record Keeping).

Finally, there are already requirements under tax law that require an open market option to be offered to all members of a DC pension scheme (Finance Act 2004). All schemes should adhere to these.

All employers should adhere to their Data Protection Act duty to provide complete and accurate data where it is necessary and their duty under the Scheme Administration Regulations to provide information reasonably required by the provider to administer the scheme. Trustees should already be taking account of their duties to ensure that contributions are properly verified and accounted for, and that their retirement processes make an open market option available to all. Underpinning all of these requirements is section 249A of the Pensions Act 2004, requiring trustees to have sufficient internal controls to be able to properly administer the scheme.

Rather than layering additional regulations on top of those that already exist, it may be more sensible to review and revise the way in which these laws are currently regulated.

12) What are the reasons for mistakes occurring and how could these be avoided?

Mistakes occur because of a number of reasons, for example:

- failure of employers to maintain correct information on their workers
- failure of workers to keep their employer and pension provider up to date with changes in their details
- failure of providers to correctly apply the information with which they are presented.

In the short term, the most sensible way to resolve these issues is to impress the importance of accurate data on all parties, and then for the regulator to take action against offenders. There is also a business case here as inaccurate data will lead to longer-term costs for providers.

13) Given what we say about administration and record keeping, what would be the impact of the suggested alternatives be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

The first four approaches described are processes that could and in any operation of sufficient scale, should already be present. Indeed, we would expect a check that the number of units allocated is commensurate with the contributions received to be undertaken after every contribution. Likewise, we would expect reconciliation of units held by a fiduciary manager, whether an investment manager or not, against those on the administration platform and allocated to members to be undertaken daily or, where movements of funds are less frequent, at such appropriate frequency. As such, we would not expect these approaches to introduce any new costs to well-run schemes and, while we would expect costs to be incurred for schemes that are less well run, any costs should be mitigated by benefits for scheme administrators and members.

The fifth approach listed is slightly different. Scheme managers are already required to have adequate checks and balances to ensure that the scheme can be properly administered (Section 249A of the Pensions Act 2004). It does seem that the requirement to hold complete and accurate common data is one that is already covered by the existing requirement, and this is borne out by TPR's guidance on record keeping.

The majority of new enrolments into pension schemes are now governed by both the information requirements set out in the employer duty regime introduced by the Pensions Act 2008 and the overriding duty under the Data Protection Act to ensure that data is accurate at point of provision. Consequently, there should already be a reasonable degree of certainty that correct data is provided at enrolment. The task then, is to ensure that data subsequently identified as incorrect or which changes during the member's lifetime, is corrected at the point at which the data is required for a scheme purpose, whether writing to the member, or moving into a phase of a lifestyle investment at a certain age. There are two complementary responsibilities here – the responsibility of the scheme manager to maintain correct data and the responsibility of the member to ensure that the scheme manager is kept up to date with changes to their details. This second responsibility is key, but is often overlooked when we discuss problems with common data in pension schemes.

We feel that fiduciary duty has an important role to play in influencing how far a scheme trustee should go in maintaining complete and accurate common data. We feel that the scheme manager must be free to make a judgement on the lengths it goes to in order to obtain missing common data, especially missing addresses. The options that a trustee has when faced with a missing address are limited and expensive and we feel that the cost of maintaining data needs to be balanced against our competing need to act in the best financial interests of beneficiaries. Given that such a power would be open to significant abuse, the regulator may wish to adopt a 'comply or explain' approach to this issue, with statutory reporting where a scheme manager takes the decision not to continue pursuing incomplete data.

Scale

We feel that there are significant potential benefits to scale both in the ability of larger schemes to pursue more sophisticated investment approaches and also to pursue economies of scale. We need to pursue scale carefully though, as there are also potential costs to its pursuit. Simply pursuing scale without examining why some larger pension funds outperform some smaller pension funds is not likely to deliver the end result customers need. Rather we need to look also at the governance structures of successful schemes and also the kind of external regulatory pressure that will be required to ensure large schemes actually deliver the potential benefits of scale. This means understanding where successful large schemes invest and also the balance of incentives operating on those schemes.

There is some evidence that larger schemes can experience higher investment returns

The literature on pension scheme performance is small, partly due to the lack of availability of scheme reporting data. The literature that exists is partly dependent on data from CEM benchmarking and variations in the findings in the literature are partly attributable to variations in how this data is cut and weighted, for instance whether the researchers risk-adjust investment returns.

Dyck and Pomorski studied a dataset containing 842 DB pension plans covering the years 1990 to 2008. This database includes 57 of the 100 largest plans in the US or 40 per cent of US DB assets, 65 per cent of Canadian DB assets and about \$1.46 tn in European DB assets. While not a census, it is a reasonably large sample of the relevant universe. The large plans in this study are also extremely large, therefore, with assets under management in the largest quintile averaging \$33bn. They found the following points:

- Scale seems to be associated with higher investment returns The largest plans outperformed the smallest by 43-50 basis points per annum.
- Compared to the first quintile, the fifth quintile, representing the largest schemes, deployed 39 per cent more of their assets using approaches other than external asset management. Large plans also manage 13 times more of their assets internally, 2.7 per cent in the first quintile versus 35.4 per cent in the fifth quintile. External active asset management is seen to be between three and five times more expensive than internal asset management.
- Larger plans devote more assets to alternatives, principally real estate and private equity. The greatest impact on the outperformance by the largest plans over smaller plans comes from exposure to these alternative asset classes.
- Plan governance, scale and investment returns are linked strongly, with the ability to set pay competitively and to avoid political influence seen as particularly important.

Looking at similar data, Andonov, Bauer and Cremers reach different conclusions, partly driven by different techniques. They find that the difference in the alpha generated between larger and smaller schemes disappears in the US elements of their sample once the data are risk-adjusted. They find the same result in the Canadian data once the data are risk-adjusted and then controlled to take account of momentum investing. They do, though, confirm Dyck and Pomorski's finding that larger funds tend to outperform smaller funds in real estate and private equity, although these typically only account for a small proportion of assets under management (3-4 per cent in the case of real estate).

⁵Dyck, I J Alexander and Pomorski, Lukasz (2011), 'Is Bigger Better? Size and Performance in Pension Plan Management'. Rotman School of Management Working Paper No. 1690724.

⁶Andonov, Aleksandar, Bauer, Rob and Cremers, Martijn (2012) 'Can Large Pension Funds Beat the Market? Asset allocation, market timing, security selection, and the limits of liquidity'. Netspar Discussion Paper No. 10/2012-062.

Larger funds can negotiate better prices

The situation with administration costs is, by contrast, reasonably clear cut. Indeed, we struggled to find material in the literature that did not show economies of scale in investment costs and in scheme administration. We did find evidence of anomalies: Andonov et al show that US DB scheme investment costs are typically higher than those of Canadian schemes in their sample. They speculate that this is due to weaker governance but offer no evidence for this.

Larger funds can be more efficient in managing cash flows and reduce the need for trading

While NEST is not yet at scale, it has been designed with that in mind. NEST operates an internal market for units between its different funds that helps minimise the need to buy or sell on the open market. This helps reduce dealing costs.

Larger funds can be better stewards

The Kay review of equity markets and long-term ownership stressed the importance of investors acting as effective corporate governors. Along with the government, we agree with the broad conclusions of the review. In this context, we feel that larger schemes are more likely to have the skills and the capacity to act as effective asset owners.

Some tentative conclusions

The overall picture therefore is one in which scale will produce economies in administration and investment cost and may also produce higher investment returns. Much of the increased return for the very largest DB schemes seems to accrue from private investment options, chiefly real estate, including infrastructure, and private equity.

From this we can begin drawing a few conclusions. Firstly, the point in pushing for scale is reduced if schemes retain current investment approaches and simply get bigger. Secondly, there is probably significant mileage in generating schemes that are large enough to access higher quality private investment opportunities. Thirdly, from a pure costs point of view there seem to be few downsides to scale.

We feel that a scheme that is best placed to take advantage of increased size would have several characteristics. First of all, the scheme would require a wide power to invest. Secondly, it would need to have an incentive or other reason to invest in the further development of its investment strategy for reasons other than the maintenance of market share. This might mean spending more on the investment strategy than would be required to maintain or gain share. Such a scheme would also require the ability to recruit and retain high-quality, specialist asset managers as it would conduct a higher proportion of its investment business in-house.

Those three factors suggest that the scale debate is bound up with the governance debate – as in other circumstances the question is 'how do we get decent outcomes for customers in the absence of competitive pressure'. We feel that trust-based schemes are best equipped to safeguard the member interest in this context. That does not mean, though, that well-run contract based schemes that are appropriately governed could not act in the same way.

14) What are the advantages and disadvantages of small and large schemes?

We feel that small schemes have some significant advantages. We believe that in the right circumstances employer-level governance may be better in small schemes, especially where there is a close connection between workers and the running of the scheme. We think that this is likely to arise on a local basis and is something we cannot generalise about.

On the other hand, as we outlined a moment ago, we feel that there are several well evidenced advantages to scale. Principally these are lower costs, owing to economies of scale and the potential for higher investment returns through access to better quality investment opportunities.

15) What options do smaller schemes have to access scale, how far are they already achieving this, and what are the barriers to this?

NEST Corporation has no basis from which to respond to this question.

16) Given what we say about scale, what would the impact of the suggested approach be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

As we noted in the introduction to this note, there is currently no overall vision for the pensions market and no overall view of how the market should serve the consumer interest. This presents a unique opportunity for the DWP to set out a view of what it expects from the market and we see this call for evidence as an important first step in the process.

We believe, though, that DWP should go further over time. We feel that now would be a good time to set out a direction of travel, such that the market has time to adapt and prepare for change even if that change is not immediate. In that spirit we have a few further suggestions in addition to our comments on the approach outlined in the consultation document.

We feel that while there is a decent evidence base on the economies of scale in administration and investment costs, much less is known about the impact of scale on the quality of investment outcomes. There is a live and relevant debate here about the relationship between scale and outcomes. If the evidence base begins to show a stronger link between scale and quality then we feel that the case for encouraging scale in provision would be substantially strengthened.

We feel that a clear lead from DWP outlining a preference for larger pension schemes would be helpful. Many of the suggestions in the call for evidence seem to be easier for larger schemes to implement and setting a clear direction of travel would eliminate the charge that DWP is aiming to achieve scale through stealth. In respect of the suggested approach, we feel that this is a fine and workable proposal but that it does not go far enough. The fundamental problem here is that schemes with the weakest governance will be the least likely to consider whether or not they are able to service member needs. That said, the pursuit of this option, which is not likely to disrupt the market adversely during staging or phasing, would constitute a signal that DWP expects the market to change in a particular direction. It would pave the way for further initiatives.

Further to the suggested approach we feel that there is the need for some sort of matching service that would allow schemes to find a merger partner or partners.

As the approach outlined in the document is not likely to lead to quality improvements in schemes with the weakest governance, we think that DWP might like to consider whether there is a case for forced mergers. We noted that TPR had suggested a similar approach during their recent consultation on the new code of practice and regulatory guidance.

Respondent information

This response is a collective effort drafted with the input of many staff at NEST Corporation and many members of NEST's Trustee. NEST is a multi-employer trust-based occupational pension scheme. At the time of writing NEST is working with over 700 employers and has 400,000 members. The NEST scheme has been operational since July 2011 and is open to new members.