DWP Consultation on improving outcomes for members of DC pension schemes

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 840,000 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 9.4 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]

[1] Employer and member numbers correct as of 11/10/20, Nest in Numbers; Member earnings and age data correct as of 01/06/2020, quarterly briefing data pack, Scheme MI

2 Response

Introductory comments:

DC market consolidation provides an opportunity for enhancing saver outcomes through better governance, administration and value. We believe this is in the best interests of all DC scheme customers, savers and employers alike.

We support the focus this consultation places on consistent reporting of investment performance, but we would also emphasise the importance of risk in any assessment of performance. Nest's focus is on delivering the right risk-adjusted returns for the particular demographic of our membership, recognising their preferences and behavioural economic drivers.

DWP's proposals to hold schemes to account on the value they offer members is the right way to encourage consolidation from smaller to larger schemes. Value is necessarily a multifaceted concept in pensions, and our member research demonstrates that an outcomes-based definition of value does not necessarily correspond to what customers are drawn to when they try to make sense of their pensions. Indeed, too often when consumers do engage with pensions they make choices that are detrimental. It is critical, therefore, that the regulatory environment continues to protect consumers from the information asymmetries and behavioural biases they encounter in relation to pensions.

We welcome proposals to make the charge cap compliance and performance fee calculation methodologies more conducive to DC investments in illiquid and alternative asset classes. Whilst we do not believe these steps alone will remove the barriers to large-scale DC investment in illiquids, we strongly support any measures that facilitate more sophisticated and diversified investment strategies amongst DC schemes.

Finally, we note the recent launch of TPR's new strategy and welcome their focus on the needs of different cohorts of scheme members. Growing numbers of automatically enrolled savers are depending on well-governed schemes which provide good value for money for their retirement outcomes. We intend to respond to the TPR's discussion paper and welcome further opportunities to work with DWP and TPR on value for money.

Chapter 2: Encouraging Consolidation

Question 1: We would welcome your views on the reporting of net returns – how many past years of net returns figures should be taken into consideration and reported on to give an effective indication of past fund performance?

We support proposals mandating all schemes report performance net of fees.

On the specific question of time horizons for net performance reporting: we support 3 and 5 years as well as since inception (at a minimum where available), on an annualised geometric basis.

We would stress however that net performance does not in and of itself demonstrate value for money. The temptation to give primacy to absolute past performance (be it gross or net of fees) is unlikely to lead to sound decision making. Focusing on absolute returns, even when reported net, could even be counterproductive to interpreting value for money.

A further reporting consideration that should be taken into account is risk. A measure of the level of risk being taken to achieve performance – risk adjusted return – gives a much richer picture of investment performance. Without a two-dimensional view there is a significant danger that schemes could engage in perverse behaviours, such as chasing short-term performance to the detriment of long-term member outcomes.

Publications like Corporate Adviser already report on scheme volatility ratios. 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 will always present a partial picture.

Question 2: Do you think that the amending regulations achieve the policy aims of encouraging smaller schemes to consolidate into larger schemes when they do not present good value for members?

It's likely that the proposals will accelerate consolidation amongst small DC schemes which are unable to demonstrate that they are delivering good value to members. By clarifying which schemes are most at risk of under-performing and providing a framework for schemes to measure themselves against relevant schemes in certain criteria, the amending regulations bring a sense of urgency and quantifiability to the remaining consolidation process.

As we wrote in our response to the 2019 *Investment Innovation and Future Consolidation* consultation, both large and small pension schemes can be well run but there are demonstrable benefits to scale that are harder to achieve in small schemes.

The move to scale can support lower administration and investment costs, improve governance practices, access to expertise, and greater portfolio diversification. However, scale is not enough on its own to guarantee good outcomes. Quality of governance is crucial, so it is important that consolidation occurs into well run pension schemes that are committed to continuous improvement. We welcome the inclusion of both quality of scheme governance and investment governance as part of the proposed value for members assessment.

Members moving to large well-run master trusts stand to benefit from consolidation because of the economies of scale they deliver and the downward pressure this applies to operational costs. This improves value for money for both members and employers.

Question 3: Do you believe that the statutory guidance increases clarity about the minimum expectations on assessing and reporting on value for members for specified schemes? Are there any areas where further clarity might be required?

With assets considerably in excess of £100m Nest is not a 'specified scheme' for the purpose of these regulatory amendments. Nevertheless, we welcome the statutory guidance set out in this consultation to support schemes to assess the value for members they offer. This guidance represents a step towards establishing industry best practice for assessing value for members amongst DC schemes.

The new guidance increases clarity about minimum expectations as it seeks to add a degree of prescription to the components and measurement of value in DC schemes. The existing TPR guidance already requires trustees to consider whether a scheme offers value for members when comparing member charges to other options available in the market. The new requirements for 'specified schemes' can be mapped to the existing mandatory assessment areas: scheme management and governance, administration, investment, and communications.

Similarly, the FCA recently consulted on the topic of value for money for schemes governed by IGCs. There is alignment between TPR and FCA on the key themes of investment quality, good customer service and reliable systems. We would emphasise that investment performance should be understood in a nuanced way, with regards to the suitability of the investment approach to the scheme's objectives and the profile of their members. For example, based on research into the investment preferences of our members, we expose younger Nest members to slightly less risk to help develop confidence in saving for the longer term. We are achieving good investment returns without exposing our members to excessive volatility, something our research shows they wish to avoid.

In deciding overall value for money, the guidance states that trustees are expected '*to give more weight to net returns, and to their ability to properly manage the scheme over the long term, rather than focusing solely on charges*.' Whilst we agree with the emphasis on performance and governance, as set out in our response to Question 1, we would also welcome some consideration of risk.

We also reiterate our position on the importance of charges, as set out in our response to the recent *Review of the Default Fund Charge Cap;* that Government should continue to secure the gains made in bringing charges down on behalf of members. 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. When economic circumstances permit, we support Government setting out a timetable to lower the cap below 75bps.

As work on assessing value for money evolves, we would welcome further consideration of how this information can be made more accessible to members. Members are unlikely to read the Value for Members statement in the Chair's Statement. There may be lessons to learn from Australia here, where attempts have been made to improve the transparency of reporting on scheme value for money. The Australian Prudential Regulatory Authority (APRA) MySuper product 'Heatmap' and the Australian Tax Office (ATO)-administered "YourSuper" comparison tool have raised concerns amongst industry schemes both in relation to methodology and accessibility, but both are intended to engage consumers and as such are worthy of consideration as we tackle a similar set of issues in the UK.

Nest recently conducted qualitative research with members to examine their understanding of value for money in pensions and to identify what criteria aid decision making or trigger action. This research that suggested most customers do not make rational utility-maximising choices – their decisions are motivated predominantly by convenience, ease, and a sense of personal ownership. It's important to recognise, therefore, that value for money is a complex concept in pensions and, irrespective of efforts to simplify it, customers will still make decisions informed by emotion and instinct rather than a clear-sighted evaluation of what it is the interest of their long-term savings outcomes. We are happy talk DWP through several waves of research we have conducted with members on the motivations informing transfer behaviours in/out of Nest.

With this in mind, we support the policy response to drive consolidation by simplifying and streamlining the assessment of value, and to make this more accessible to members, but it is critical that the regulatory environment continues to evolve to protect automatically enrolled customers who behave in ways that are economically sub-optimal.

We would like to see the principles that are being developed to assess value for members applied in a similar way to DC-DC transfers – so customers are making comparisons on a like-for-like basis. We are concerned about consumer detriment arising from members transferring to schemes charging at or close to the charge cap without any understanding of price difference and impact on savings. Indeed, every month we pay out transfers of over £1m to pension arrangements which charge more than Nest.[2]

Technology is increasing the ability of firms to capture pensions assets in easy, single-step processes. Growing numbers of firms offer attractive mobile apps that enable people to easily consolidate their saving into a single pot. Whilst this can add to consumers' sense of control and indeed overall level of engagement with saving, some of these firms charge significantly above the market rate to manage those assets: so, all else being equal, outcomes for those shifting their pots across will be poorer. Despite charging at or close to the 0.75% charge cap, the attractive front end offered by some schemes is in some cases accompanied by only a basic tracker investment strategy. As with cost, we would emphasise that a measure of risk-adjusted return represents a critical indicator of value and of member outcomes.

We would like consideration to be given to whether some regulatory friction should be built into DC-DC transfer journeys in order that members are encouraged to pause and consider the relative value for money of the schemes they are transferring between. This is not easy without a common measure of value for money, but as a minimum members could be required to tick a disclaimer to say that they had considered the relative cost of the two schemes and understood that switching may leave them worse off.

[2] Nest Scheme MI, 2020. There's no contribution charge applied to transfers at Nest, and we only charge our standard 0.3% annual management charge to the transfer value.

Chapter 3: Diversification, performance fees and the default fund charge cap

Question 4: Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?

As we understand it, the policy intent is to allow DC schemes to invest in illiquids and private markets from which they have so far been largely excluded.

There is a broad spectrum of fee models within illiquid assets, with real estate funds and private credit funds typically (though by no means uniformly) at the lower end, which large schemes like Nest have begun to make investments in. Few DC schemes are in a position to make even these investments, as the level of the fees varies very significantly with the scale of the allocation. Meanwhile traditional and pervasive fee models in private equity and venture capital funds exclude the vast majority of, if not all, DC schemes.

In-year adjustment to prorating requirements for performance fees represent an incremental step toward making illiquids more accessible to DC schemes.

However, in practice, in-year prorating is perhaps more accommodating to hedge funds which typically accrue performance fees over a much shorter investment horizon. In-year adjustment is unlikely to be relevant in upwards of the first five years of a typical private equity investment because performance fees are less likely to accrue during those years due to the J-curve effect in these types of investment.

Question 5: What should we consider to ensure a multi-year approach to calculating performance fees works in practice?

Again, a multi-year approach to calculating performance fees is an incremental step. However, this will only work where the charging structures levied by the majority of the private markets fund management industry evolves to match the methodology.

We don’t expect performance fees to stop being part of private markets, so irrespective of adjustments to the way fees are calculated, the total level of fees will remain too high for many schemes to access them.

Question 6: We are proposing a five-year rolling period. Is this appropriate or would another duration be more helpful?

As above, a five-year rolling period is incremental step but does not solve the wider problem of the level of fees and their term structure levied by most private markets fund management industry.

Question 7: We are proposing offering a multi-year option as an alternative to an in-year option for schemes. Do you have any suggestions for how to improve this offer?

We believe that in order to see a tangible in-market effect i.e. more DC schemes accessing illiquid investments, the DWP may need to consider a more radical approach. If changes to performance fee calculation methodologies are the extent of the policy reforms, then the investment management industry would still need to drastically reduce their fees (and therefore their revenues) which most likely cannot be offset by cost-savings and economies of scale in the short to medium term.

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Question 8: To what extent will providing a multi-year smoothing option give DC trustees more confidence to invest in less liquid assets such as venture capital?

Question 9: Do the draft regulations achieve the policy intent? Do you have any comment on the definitions used?

We welcome the proposals to the extent they give greater consideration to performance fee measurement. However, these steps alone are unlikely to significantly change the dial on DC investment behavior in illiquid and other alternative investment classes.

Chapter 4: Using transparency as a prompt

No questions

Chapter 5: Updates to statutory guidance: Reporting costs, charges and other information

Q10. Do you believe that the proposed updates to the statutory guidance increases clarity about the minimum expectations on both the production and publication of costs and charges information?

The proposed changes to the 'Reporting Costs and Charges' guidance are directed at all schemes. The draft guidance calls on schemes to produce a costs and charges illustration for each default scheme.

Nest operates a combined charging structure of 1.8 per cent on contributions and 0.3 per cent AMC, which is broadly equivalent to 0.5 per cent AMC. Members are automatically enrolled into a Retirement Date Fund which corresponds to the year they are expected to retire. As a result of this approach Nest currently has approximately 50 Retirement Date Funds. Transaction costs for the Nest Retirement Date Funds are between 0.000 and 0.062 per cent.

We currently produce three illustrations in respect of the Retirement Date Funds, based on the member's age at joining Nest (i.e. age 22,45 and 55) this approach enables us to illustrate the effect of costs and charges on a member's fund, based on the investment phase the member was in when they joined Nest (i.e. foundation, growth or consolidation phase).

If Nest were to treat each of the Retirement Date Funds as a separate default fund, this would result in the production of illustrations for approximately 50 funds, all with the same level charges and a negligible difference in transaction costs. This would be time consuming and costly and would result in an illustrations document that was unwieldy for members to follow, as they would have to trawl through pages of illustrations to find the fund they are invested in.

The new draft guidance also states that where the product is being used for flexi-access drawdown, one or more expected representative future withdrawal rates should be assumed. Although Nest does not offer flexi-access drawdown, we do have a fund that is designed to enable managed partial UFPLS withdrawals. As this fund is a default option for members who meet a set criteria at their intended retirement date we assume that, were this guidance applied to larger schemes, we would be required to produce an illustration in respect of this fund assuming one or more expected representative future withdrawal rates. We would welcome clarification on the application of this proposal to partial UFPLS.

Chapter 6: Other changes to legislation

Question 11: We propose that where the default arrangement includes a promise, the trustees of the scheme should be required to produce a default SIP.

We propose that this should be produced within 3 months of the end of the first scheme year to end after the coming into force date.

- **(a) Do you agree with this policy?**
- **(b) Do you agree that the legislation achieves the policy?**

We agree that all schemes should be required to produce a SIP.

Question 12: We are proposing that, for relevant schemes, charges and transaction costs should be disclosed for any fund which members are (or were) able to select and in which assets relating to members are invested during the scheme year.

- **(a) Do you agree with this policy?**
- **(b) Do you agree that the legislation achieves the policy?**

We do not have a view on this question.