Defined Contribution Investment Forum

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Barriers to Innovation in DC

Dedicated to promoting investment excellence

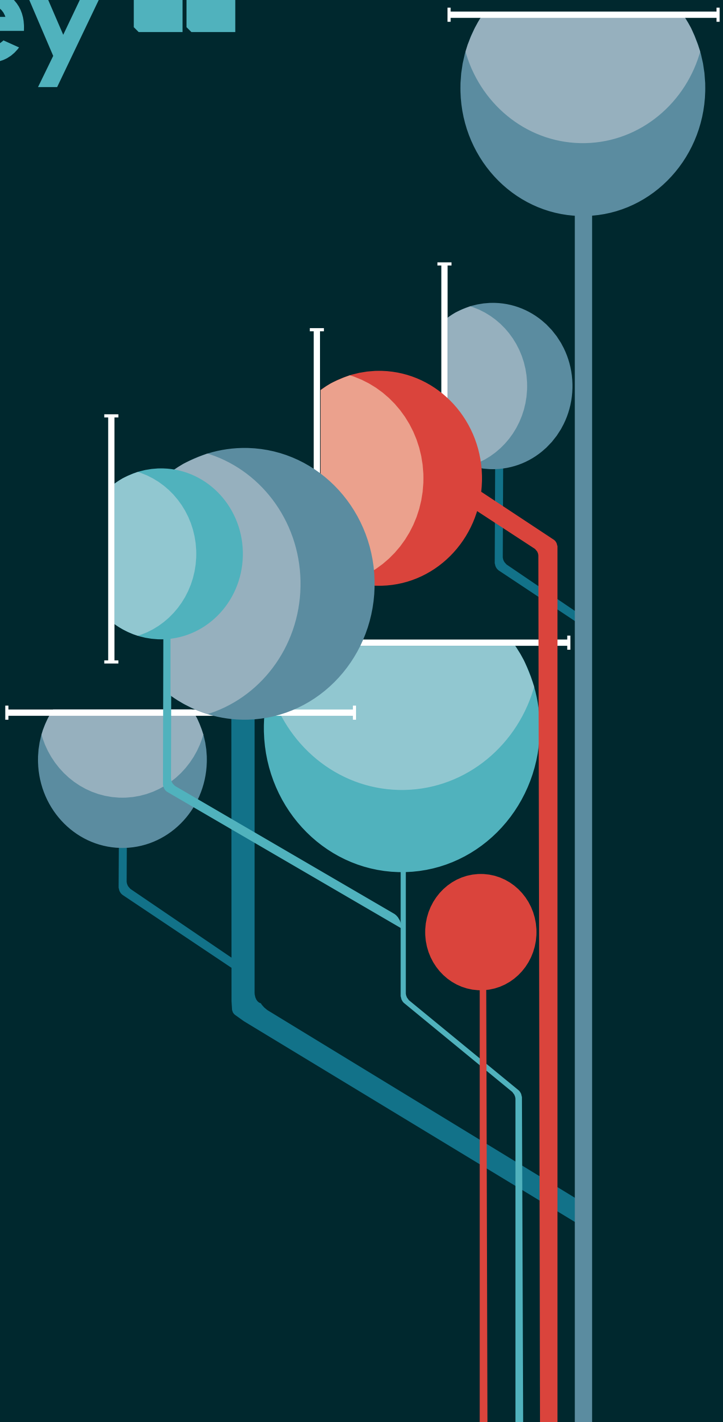
dcif.co.uk

About us

The Defined Contribution Investment Forum (DCIF) aims to exchange ideas and develop initiatives to promote investment excellence in Defined Contribution (DC) pensions in the UK. The DCIF consists of investment firms and selected other industry participants who believe that members in DC pension schemes deserve the best possible investment services to help them meet their retirement objectives.

❝Those DC assets keep me awake at night a bit more. That's people's real money❞

– Paul Jebson



Introduction

At the last count, almost seven million members of defined contribution (DC) pension schemes had started saving because of auto-enrolment. It's vital to get their investment strategies right from the start. Why? The most fundamental reason is the fact that many savers will rely on their DC pensions to give them a comfortable retirement. In addition, savers who have been auto-enrolled may not realise that their money is invested, putting pressure on pension fund decision-makers to ensure they are building default funds that will deliver growth over the long-term.

A group of DC experts who recently gathered for a round table discussion, hosted by the Defined Contribution Investment Forum (DCIF), voiced their concerns that members are not receiving access to the most innovative ideas in the investment universe. This could mean their pension pot will not grow as large as it otherwise could. Why? A combination of regulatory, political and systemic factors are limiting access to some of the best ideas in investment.

This paper will examine a selection of barriers to investment innovation, with two specific focuses: to what extent the charge cap limits innovation, and the degree to which schemes are currently able to access illiquid asset classes. We will also share examples of innovation the roundtable participants described.

The key recommendations that the roundtable participants made are as follows:

Preserve the current level of the charge cap. A reduction in the charge cap would squeeze investment out of the equation at the expense of other scheme costs, such as administration, communications and governance. At a lower price point, access to the whole universe would be impossible, leaving schemes with no option but to invest purely in passive, index-tracker funds. Panellists also warned that members of smaller schemes, even those with paternal sponsors, could suffer disproportionately if the level of the charge cap were to be reduced.

However, the current level of the charge cap was agreed to be sensible, giving schemes a clear framework to work within. The panellists also noted that innovation is definitely occurring and some schemes are taking the time to construct great investment solutions.

Make it easier for DC schemes to invest in illiquid asset classes. For instance, it is remarkable that overseas pension funds are snapping up UK infrastructure, while most UK DC schemes are not, the panel said. At the moment, platforms require asset managers to provide daily dealing, which is not always compatible with infrastructure investing, which typically requires investors to commit for the longer term.

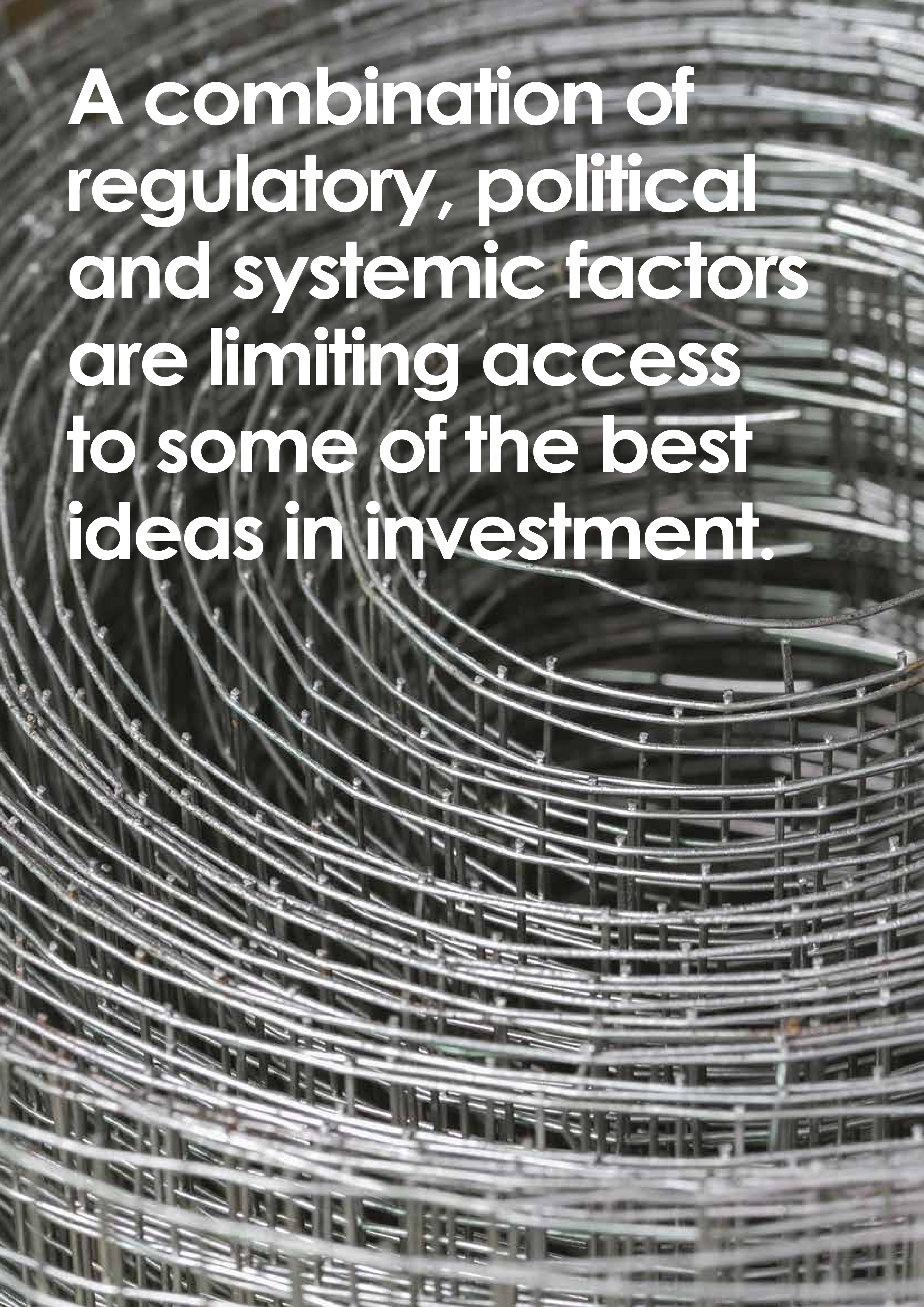
A solution to this problem must be found in order to help DC savers gain access to the illiquidity premiums that defined benefit (DB) savers have been privy to in the past. This problem could diminish as funds grow and economies of scale develop; however, it could be worthwhile to explore the idea of a Pensions Infrastructure Platform-style organisation for DC schemes.

The stakes are high and to safeguard several generations of members' comfortable retirements, it is vital to get DC investment right today. After all, members of DC schemes lack the paternalistic underpin of their defined benefit predecessors. Paul Jebson, chair of Standard Chartered Trustees' investment committee and his colleagues run both defined benefit (DB) and DC schemes. Jebson observed: "Those DC assets keep me awake at night a bit more. That's people's real money."

The roundtable

The DC Investment Forum brought together seven DC decision-makers from across the industry to discuss barriers to innovation in the market. We thank the seven for taking the time to share their invaluable insights and perspectives, and their names and affiliations are listed below. The roundtable debate took place on the 15th November 2016 and was chaired by the DCIF's executive director, Louise Farrand.

- **Imran Razvi**, public policy adviser, the Investment Association
- **Inder Dhingra**, independent trustee, Law Debenture
- **Paul Jebson**, chair of investment committee, Standard Chartered Trustees
- **Andy Dickson**, investment director – UK institutional business, Standard Life Investments
- **Terry Yodaiken**, head of product – EMEA, First State Investments
- **Mike Weston**, chief executive, the Pensions Infrastructure Platform
- **Steve Budge**, principal, UK DC & financial wellness, Mercer



A combination of regulatory, political and systemic factors are limiting access to some of the best ideas in investment.

1: The charge cap

A race to the bottom

At present, the cap on charges is 75 basis points. The DC experts around the table unanimously agreed that a reduction in the charge cap would result in less innovation.

Imran Razvi, public policy adviser at the Investment Association, said: "If you're going below 75 basis points to 50 basis points, it then becomes very difficult to innovate."

Andy Dickson, investment director within Standard Life Investments' UK institutional business, agreed: "I think you certainly can get a good quality, well diversified, investment strategy that supports DC members within the current charge cap constraint. However, there is a very real risk that if the fee budget was to be further compressed then that would indeed stifle innovation."

Some areas of the investment universe are already difficult to access, with the charge cap at its current level. As Terry Yodaiken, head of product for EMEA at First State Investments, explained: "It would be beneficial to include illiquid investments and other asset classes in DC portfolios. We see the charge cap as a significant impediment to that. We also feel that there could be some interesting innovative structural solutions that you could think about in terms of helping schemes and those platforms manage around that liquidity point, but again, the investment in the design of that type of process and/or facility is significantly constrained, in our view, by the charge cap."

Investment is often the first area of the scheme's overall fee budget to be culled; therefore a reduction in the cap would mean members would face the risk of having less comfortable retirements.

Razvi said: "One of the things that really concerns us is that I've had conversations with [asset managers] where they've been dropped from a pension scheme's default fund because the cost of other elements of the value chain are taking up a significant portion of the cap. If they are being dropped because the client is not happy with what they've been provided, then that's one thing – that's the right decision. But to be told: 'We like what you are doing but we don't have the budget for it', that's got to be a concern.

"From what I understand – although I'm no expert on the costs of other services within the pensions value chain – they are taking up a significant portion of the cap. I'm not sure how much variation there is and the level of fees across different service providers, but the sense I have it's generally easier to change your investment solution rather than other service providers within the value chain."

What's really hindering innovation?

Inder Dhingra, an independent trustee with professional trustee firm Law Debenture, is not convinced that it is economies of scale which are preventing schemes from accessing smart investment solutions. Instead, it is about how committed the trustee board is to finding the right investment design. One trustee board he chairs has had six to eight intensive meetings annually for two years, dedicated to tackling this very issue. Once implementation is in sight, he plans to cut this back to four intensive meetings a year.

He said: "We spent a great deal of time just understanding what we wanted, because the market hasn't quite panned out. In the DB space, the solutions are out there, it's a matter of just educating ourselves to actually do it. However, in DC the market is in a much earlier stage of development, so you need to be prepared to be clear about what you want. That's why we are spending more time on the subject."

Innovation in the journey through life

"Where I need innovation more than anywhere else right now is not in complex illiquid types of asset classes. There, to some extent, we can get that through managers providing us with a combined diversified growth fund with a sleeve for illiquids and I'm quite content to leave it there. I don't think I need any more complexity than that.

I think innovation is more around the evolution of the fund from a young member as they go through their life journey to retirement and then into retirement. How do you manage that whole process of going from seeking high returns, with an appetite for taking higher risk, through to medium return, medium risk, then towards the end of a member's working life, into a lower risk profile and then into retirement, potentially providing members with retirement solutions, too?

We all have life plans. The innovation issue is really around: how you construct products when you don't know when somebody is going to retire and they don't know what they are going to do in retirement, in terms of drawdown, taking an annuity, and so on. In that uncertain environment, you need a different sort of composition of products. I think that's where I'd like to see more innovation."

– Inder Dhingra

The price is right

If the charge cap were to be reduced, it could be at the expense of members of certain types of pension schemes, experts around the table warned.

Smaller schemes could suffer. "Smaller schemes do have a tougher time – there's no question. You do have buying power in larger schemes," said Dhingra. "I think if the charge cap were reduced, the industry would be significantly constrained, more so for the contract-based schemes because they have to cover all their costs, that would push down the product to be very cheap indeed, because you have to pay for everything else out of the 50 basis points. It would be ridiculous."

Employees of less paternalistic companies are another group which could face poorer outcomes. The extent to which the charge cap affects scheme members' investment outcomes depends on the employer's willingness to foot the bill for the other charges which are included in the cap, argued Dhingra.

He said: "In an employer's trust-based scheme, the typical structure is that the employer pays for all the admin-related costs, so the member-borne costs are purely the [investment] Annual Management Charges. The charge cap doesn't quite bite. There's enough room there to come up with innovative products. It's not the charge cap that bites, it's actually the daily liquidity demands. I would love for our members to be in the less liquid funds, but the reality is that regulation gets in the way of that."

For more on the constraints of daily pricing, see section 2, p9

Members of contract-based schemes and master trusts could also see worse outcomes as a result of a reduction in the charge cap. When employers choose a contract-based governance structure, or to outsource their money to master trusts, all costs are typically presented as a single number, said Dhingra. "Then, all costs have to be passed onto members, in effect. [Members] have to pay for the administration platform, the beautiful communications, the apps, and the underlying assets and the management charges on top of that. And then the basis points do really begin to bite and you are really constrained to fairly vanilla type asset classes."

What's your top regulatory frustration?

One of the things that we find a little bit frustrating is that regulation is working for the highest denominator and the lowest denominator. We are required to take regulated advice, which is an interesting concept. I have an investment committee with close to 100 years of market experience, and yet you're basically forced to write a cheque for someone to tell you what it is you want to implement after you've told them what it is you want to implement. So I find that a little bit frustrating. But I do understand that at the other end of the scale, there are plenty of schemes out there where taking regulatory advice would be a really good idea.

– Paul Jebson, Standard Chartered Trustees

However, Dhingra is confident that investment innovation will prevail, pointing to the evolution of investment solutions like smart beta. "There are definitely changes coming through the system, so I don't think barriers to innovation are there per se to stop us. It is more that the focus has been on DB for so long, the industry is only just beginning to catch up with the needs of DC. I'm confident that we will get a lot more innovation in DC as time goes on."

The relationship between price and value for money is complex. Many employers have been stung by the expense of spiralling DB costs in the past, and may welcome DC as a cheaper, simpler HR solution. However, you get what you pay for, warned Jebson. "I think if you're an employer with all of the complexity surrounding DC, I can see some suboptimum decisions being made. I can see people maybe not being willing to spend as much as they might to get an optimum solution.

"That bleeds into the issue of the charge cap. But it's also relevant in terms of the willingness to do something different. The big passive managers would have you believe that that's the solution to everything. And if we are just forced down the path of just buying the cheapest tracker funds, you'll never get any innovation in anything, end of story."

Whilst agreeing that a lower charge cap would stifle innovation, Steve Budge, principal for UK DC and financial wellness at Mercer, pointed out one benefit of a charge cap. "It's really made sure, from an adviser's and a design point of view, that we highlight what is the key focus of the portfolio you are creating. You've got a fee budget, so you have to spend it wisely. How do you get the best value? That's driving a lot of conversations right now."

2: Accessing illiquid asset classes

Why are infrastructure and DC savers so compatible? As Mike Weston, chief executive of the Pensions Infrastructure Platform (PIP) said: "Infrastructure will give you a return that is better than gilt yields during the accumulation phase, long term links to inflation, and a relatively low risk cashflow that's a bit like an annuity. So actually, in the decumulation phase, it's also potentially a pretty good asset for a DC scheme. It's a question of making it work."

Overseas DC schemes are already well-versed in the benefits of infrastructure. Weston explained: "As UK investors, we naturally look across the water at what the Australians are doing. The Aussie super funds are all DC-based. One of the reasons for PIP being set up was: Why are the Australians coming in and buying all the UK infrastructure? They are doing it because they are taking a view that infrastructure is a great asset for their super funds for their long-term members' interests. And all the positive cash flows that they're getting out of those schemes are allowing them to come over and buy up lots of assets."

The problem is widely acknowledged in the DB world. Indeed, the Pensions Infrastructure Platform (PIP) was set up to help DB schemes access infrastructure as a collective group. The economies of scale involved in gathering a large group of pension fund investors give them greater bargaining power on cost. However, no equivalent to the PIP exists for DC schemes. Moreover, 2013 research by the DC Investment Forum concluded that there are no regulatory barriers (aside from the charge cap) which stop schemes investing in infrastructure. So what is getting in the way?

The first barrier is that most DC investment platforms require asset managers to provide funds which offer daily pricing. Typically, infrastructure's pricing changes less regularly than that, because by nature it is not bought and sold daily.

This could be a problem for DC members. As Jebson observed: "One issue is if you've got a pretty savvy scheme membership, who are used to being able to log in online at work and look at the valuation of their pension pot as of last night. If you've got something in there that's actually not changing its price over 28 days, I can see a few phone calls to the help line saying: 'Hey, how come it's just moved by 3 percent?' So there are some practical issues around member expectations."

Educating engaged members in the characteristics of illiquid asset classes is one way to overcome that barrier. As DC assets grow, it will also get easier to provide more active pricing, said Weston.

In future, pressure will grow on the government to make investing in infrastructure easier for DC schemes. As Weston said: "The UK government talks about using pension schemes assets to fund UK infrastructure. Well, if you look at the dynamics, the DB schemes are all going for insured solutions or in run-off and shrinking. Ok, we've got a long way to go, but the rising asset pots are all coming from the DC and auto-enrolment. So if the government really want lots of money for infrastructure, they should be making it easier for DC schemes to invest in it.

He continued: "The economy of scale argument is really interesting, because of course PIP was set because people assumed that and agreed that DB schemes were sub-scaled, individually, in terms of their allocation to infrastructure. What I'm hearing is that in DC, it's more of that in spades effectively. Arguably, is there a collaboration mechanism for a DC in infrastructure? Just like there is for DB? Well, possibly."

Conclusion

The one thing I would like to see changed is more investment by platforms on dealing with operational challenges around liquidity. If we all agree there isn't a true regulatory constraint to liquidity, then the constraint has been driven up from an operational perspective. Let's innovate there because everything will flow from that perspective.

- Terry Yodaiken, First State Investments

Daily liquidity. If you are effectively having to pay somebody to take an illiquidity mismatch to get daily liquidity in an illiquid asset, then that's value that's being lost to the members.

- Mike Weston, Pensions Infrastructure Platform

I agree with those, and would add permitted links rules in the UK, which control how DC schemes invest. This is probably a key one right now; it is actually a barrier to innovation and limits DC schemes accessing DB investment choices

- Steve Budge, Mercer

For me, it's issues relating to and through retirement. I would like to see innovation around people seamlessly moving into retirement without having to pay big costs to transition between asset classes, without having to worry about turning your portfolio in and getting into a draw-down or a managed state. At the moment, it's actually like a cliff, chuck people out of the bath tub and into the ocean. 'You're on your own now – here's your money and off you go!' It's a bit unfair.

- Inder Dhingra, Law Debenture

I would introduce policies to force some sort of consolidation because it seems to be clear that the more assets you have, the more choice and buying power you have.

- Imran Razvi, Investment Association

I agree with all the other ideas and would add: how do we as an industry deal with small pots?

- Paul Jebson, Standard Chartered Trustees

Two words: Regulatory stability. If you think about the impact it could have on stability and consumer confidence and improving trust, it would be immense. From the provider's perspective, stability and clarity as to what costs are would be a huge benefit in allowing for further innovation.

- Andy Dickson, Standard Life Investments

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