The Trustee toolkit downloadable

How a DC scheme works 2014

Tutorial four: Value for members and charges

By the end of this tutorial you will better understand:

- the importance of ensuring the scheme offers good value for members
- what an annual management charge is
- what the total expense ratio is
- what the portfolio turnover rate is
- how different charging structures can impact on good member outcomes
- steps trustees can take to ensure members understand charges and their impacts

This tutorial is part of **Scenario two**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Introduction

The Tutorial: 'Good member outcomes' introduced you to the risks that might affect the outcomes for a DC member.

In this tutorial, you will learn more about the ways in which charges can be applied to DC schemes so that you can reduce the risk that members are subject to excessive charges, and ensure that you are compliant with the legislative charge restrictions where applicable.

You will also learn about the trustee's role in considering whether the charges are reasonable in relation to the expected investment returns and the services provided by the scheme - whether the scheme provides good value for members.

Most trustee boards have to carry out a value for members (VFM) assessment at least annually and report on the outcomes in their annual chair's statement. The assessment covers the extent to which particular member borne charges and transaction costs (in so far as trustees are able to determine them) represent good value. The chair's statement must also include disclosure of member borne costs and charges.

Trustees should seek advice as to the extent to which these requirements apply to arrangements within their scheme.

Whether or not they apply, all members should receive good value from their pension scheme.

Focus on the risk

The risks associated with high charges should be considered in the context of whether the scheme is offering 'good value for members' as lowest cost does not always mean good value. In some cases there are restrictions on the level of charges that can be borne by members but, again, compliance with the charge restrictions does not automatically equal good value.

What is meant by 'good value'?

If you are considering whether to renew a mobile phone contract or reviewing your household insurance policy, cost will be an important factor. However, you will almost certainly take other factors into account and you may not choose the cheapest option when you make your decision.

In most cases, you will make a judgement about which elements of the transaction you value most and what you are prepared to pay for those elements. This is what is meant by good value.

How does this apply to pension schemes? Trustees and employers will make similar types of judgement when they consider the value of an existing pension scheme, the components within it, and the costs associated with these components.

Good value in a pension scheme

There are many components within a pension scheme that may contribute to the overall value provided to members. For example, these include:

- the scheme's governance framework
- security of assets
- employer contribution to the cost of services
- the value for money of services paid for by the employer
- employer contribution to member funds
- value over the longer term

Although these components do not form part of the legal duty to assess value for members, which focuses on member-borne costs and charges only, trustees may wish to refer to them in the chair's statement to provide context for their report on the assessment.

Legal duty to assess value

Trustee boards that are required to assess value for members need to consider whether particular costs and charges deducted from members' pots or contributions (the costs of membership) provide good value in relation to the benefits and services provided for those costs (the benefits of membership), when compared to other options available in the market.

Trustees are also expected to include in the assessment benefits and services where the costs are shared between members and the employer, even where members cover only a small proportion of the overall cost of a service or bundle of services.

Good value does not necessarily mean low cost, provided any higher costs can be justified by improved benefits such as the quality and/or scope of a particular service. Because the investment experience delivered to the member is such an important determinant of good member outcomes, investment returns and the impact of costs and charges on them are likely to be among the most critical elements of a value for members assessment.

Are there any charge restrictions?

Yes, there are restrictions on the level of particular charges that can be borne by members of default arrangements in schemes being used by employers to comply with their duties under automatic enrolment legislation. This is capped at 0.75%.

Carrying out a VFM assessment

There is no single process for completing the assessment and it's important to consider the nature of your scheme and its membership when developing an approach. Broadly speaking, the assessment is likely to involve four stages.

1. Gather: Gathering information on what the scheme provides for members and at what cost

For example: what do members receive for what they pay across the core areas of scheme governance and management, investment, administration and communications?

2. Assess: Assessing the benefits (scope and quality) of scheme services to members

For example:

- are the benefits provided by the scheme's services suitable for, relevant to and valued by members?
- have the services performed effectively over the past year and it is likely that they will continue to perform effectively?

3. Evaluate: Evaluating the benefits against the costs

For example:

- does the scope and quality of each service justify the relevant costs and charges?
- does the scope and/or quality of a particular service justify any differences in cost when compared to similar schemes and other options available in the market?

4. Report: Reporting on the outcomes in the chair's statement and taking action to address poor value

For example:

- did the trustees prepare for the assessment?
- what process was followed?
- what were the outcomes?
- can the trustees justify the conclusions they reached?
- what action will they take to address areas of poor value?

To allow a greater level of comparison between schemes in the future, it's worth considering publishing the chair's statement.

You can learn more about assessing value for members, including an illustrative four step process, by reading the guide to value for members at **www.tpr.gov.uk/value**.

Key tasks

In general, trustees will need to carry out certain tasks in order to complete the assessment. These may include:

- researching the characteristics of their scheme's membership (eg age, salary, fund size)
- asking members about their experience of particular services (eg via a survey)
- assessing the extent to which services have helped them to comply with their legal duties and meet the standards in the DC code of practice
- considering whether services have met their objectives, targets or performance measures

Examples

We will now look at some example components that might be included in a value for members assessment and some specific questions trustees might ask themselves about their scheme.

Net investment performance

- Are the investment returns delivered to members in line with stated performance objectives and industry benchmarks?
- Are there any costs and charges related to investment which are higher than industry benchmarks delivering commensurate improvements in net investment performance?

Investment service provision (including types of investment offered)

- Does the scheme offer the types of investments that members want to invest in, and are they suited to the membership profile?
- Are there an appropriate range of investment options on offer for members who choose their own investment strategy?

Communications

- Are investment options clearly explained?
- Does the scheme provide members with information which will help them to make decisions, for example on investments and at pension age?
- Are members able to get up-to-date information about their pot easily?
- Is the information that members currently receive annually about their pension clear and easy to understand?
- Does the scheme offer online access to information?
- Does the scheme provide access to face-to-face help or a telephone helpline for members?

Administration

- Are service level agreement targets appropriate and are they being met?
- Are there problems with the services provided by the administrator or with the data, eg indicated by member complaints?
- When members contact the administrator, do they receive a prompt response which answers their questions?

Mitigating the risk

Overall, trustees should act as demanding consumers on behalf of the schemes' members.

Using judgement

While it's important for trustees to understand what their members value as far as possible, ultimately they will need to use their judgement to determine whether the scheme offers good value. Overall, trustees should act as demanding consumers on behalf of the schemes' members.

Raising concerns

While trustees can often address issues such as poor quality administration or poor investment returns by raising these directly with the service providers, where they have concerns about value for members that are not within their scope to resolve, they should draw these concerns to the employer's attention, making clear the impact on members. Trustees that must carry out a value for members assessment should also report on these areas in their chair's statement.

Making changes

As a consequence of these discussions, the employer and / or trustees may determine that the interests of members (both active and deferred) may be better served by, for example:

- requiring improved service levels
- re-tendering for services
- negotiating lower costs
- adding or removing scheme components
- changing provider

Ongoing monitoring and evaluation

Trustees should keep value for members in mind on an ongoing basis, including particular issues or risks on the scheme's risk register and taking it into account before making decisions relating to services to the scheme.

Separately they should carry out a periodic strategic review of their approach to assessing value for members and consider whether it remains fit for purpose.

Charges

In order to make value for members assessments, trustees need to ensure that they have a good understanding of how all of the costs and charges are incurred and applied on their scheme. The costs on DC schemes fall into two main categories: those related to the administration of the scheme and those related to managing the investment funds. This may include transaction costs. Transaction costs are the costs incurred as a result of the buying, selling, lending or borrowing of investments.

What form do charges take?

Charges take many different forms including:

- upfront charges on money being invested (ie on contributions)
- charges based on a percentage of the value of the member's pot (or funds)
- costs reflected in the unit price of the investment funds
- flat rate annual charges
- charges for redirecting contributions
- charges for switching between investment funds
- charges on funds being disinvested

Who pays the charges?

Trust-based schemes vary as to which costs are paid by the employer and which are paid by the member. In many cases, the employer bears some or all of the costs related to administration and running the scheme, eg costs of advisers and legal costs.

In some schemes, the employer only cover costs incurred by employed members so the charges are higher for deferred members. In these cases, trustees should consider whether extra charges are reasonable and appropriate and should ensure that members leaving the organisation are made aware of any change in the charges.

Since April 2016, in some circumstances, it has been against the law for deferred members to incur higher charges than active members.

Charges cap

There is also a cap of 0.75% on the level of particular charges that can be borne by members of default arrangements in schemes being used by employers to comply with their duties under automatic enrolment legislation.

Some types of charge or cost are excluded and don't count against the cap, such as transaction costs.

Charges for DC schemes

There are various costs and charges which may be deducted from members' contributions or retirement accounts in a DC scheme. In this tutorial we will focus on:

- annual management charge
- total expense ratio
- portfolio turnover rate

We have created a downloadable 'charges glossary explaining some of the terms frequently used to describe these costs and charges, which is available on the Resources page.

Annual management charge (AMC)

Most DC schemes apply annual management charges to their funds. This charge is essentially a 'headline figure' as other charges will also be applied to funds. If the scheme offers a number of funds then each fund is likely to have a different AMC.

AMC explained

AMCs are usually expressed as a percentage of the fund in which a member is invested (eg 0.3%) and are usually reflected in the daily price of the fund.

A simple example

This example is for illustrative purposes only and assumes no additional contributions or investment return.

Fund A: £10,000 x 0.2% = £20
Fund B: £10,000 x 0.5% = £50

If a DC member had invested £10,000 in fund A with an AMC of 0.2% and £10,000 in fund B with an AMC of 0.5% then they would pay £20 and £50 respectively in AMC charges on the two funds over a 12 month period. The price of the fund can be affected by this charge, for example, on a daily basis.

What does this charge pay for?

The majority of the AMC charge goes to the investment manager to cover the costs of running the fund. These include costs arising from expenses from resources supporting the investment managers' decisions, such as:

- research and analysis of the relevant markets, and
- portfolio managers which are appointed by the fund manager

Charges for actively managed funds will typically be higher than for passively managed funds Certain costs are not usually covered by the AMC, including stamp duty on the purchase of shares and stockbroking commissions for buying and selling investments.

Can the term AMC be used for other charges?

The term AMC is used in different ways. Sometimes the AMC quoted covers other costs which do not relate to investment (eg for administration). This is common in 'bundled schemes' where an insurer provides the administration as well as the investments.

Total expense ratio (TER)

The TER (sometimes known as 'ongoing charges') is another way of expressing the costs and charges that apply to an investment fund or pension scheme.

TER explained

The TER will always include the AMC but it is worked out on a historic basis for the previous year and is therefore also able to include other fees and charges such as legal and audit costs, custodial fees and investment administration fees which have been applied.

A simple example

For example you could consider the TER in relation to renting a house. You pay the rent, which is the headline figure of how much it costs to rent the house (for example the AMC). But to live there you also need to pay additional costs such as utility bills. These additional costs are not paid to the landlord (compare to the investment manager) but are a necessary part of living in the house (compare to investing in the fund). These additional costs are variable and you can estimate them but do not know for certain in advance.

What is TER used for?

The TER is a more complete measure than the AMC of what the member is paying for the services they are getting, but despite the name, it does not capture all the costs and charges that apply to members' retirement accounts. It does not include the transaction costs incurred when buying and selling investments or the taxes associated with those transactions. Nor does the TER capture other costs such as those associated with entering or exiting from a fund or a scheme.

Why doesn't the TER include transaction costs?

Transaction costs are not included in the TER because these costs are already reflected in the investment performance of a fund and do not directly increase investment manager revenues. However, trustees need to have an understanding of the types and levels of transaction cost that are incurred by different investments and include them in any value for members assessment.

Given the complex nature of transaction cost disclosure, trustees will find it helpful to contact investment managers and product providers well ahead of the scheme's year end to ensure they receive timely and appropriate information.

Trustees need to explain any circumstances where they have been unable to get hold of particular information in the chair's statement. When reviewing investment mandates trustees should consider including the disclosure of transaction costs as both part of the selection criteria and as a contractual term.

Portfolio turnover rate (PTR)

The PTR is a measure of how frequently an investment manager ‘changes’ or ‘turns over’ the underlying investments of a fund during a defined period of time, usually a year.

PTR explained

An investment manager changes the underlying investments by buying and selling securities.

The PTR is calculated by taking either the total amount of securities bought or the total amount of securities sold (whichever is less) over a specified period and dividing by the total asset value of the fund.

A simple example

Transaction costs are affected by the level of activity in the fund.

- Some active investment managers buy and sell shares frequently, in an attempt to make profits
- Passive investment managers tend to buy and then hold stocks.

Whilst transaction costs tend to be higher for more actively managed funds, the level will, in part, depend on the ability of the investment manager to negotiate good terms with the other parties that they trade with (such as the broker).

An investment fund with a high turnover rate is likely to incur more transaction costs than a fund with a lower turnover rate. Significant additional expenses can reduce investment returns.

What is PTR used for?

The PTR can give an indication of what the transaction costs are likely to be, based on the rate at which investments are ‘turned over’. In conjunction with the TER it can provide trustees with a more complete picture of the likely costs than the TER on its own is able to provide.

Comparing charges

Three scheme members are comparing the charges of the funds available to them.

- Member one has a total fund value of £2,000.
- Member two has a total fund value of £20,000.
- Member three has a total fund value of £100,000.
- Fund A has an AMC of 0.6%.
- Fund B has an AMC of 0.5% plus a flat annual change of £30.

With just these charges in mind, which one of the following statements is true about these three members over a one year period?

1. All three members are better off in Fund A
2. All three members are better off in Fund B
3. Members one and two are better off in Fund A but member three is better off in Fund B
4. Member one is better off in Fund A but members two and three are better off in Fund B

Answers are at the back

Focus on the risk

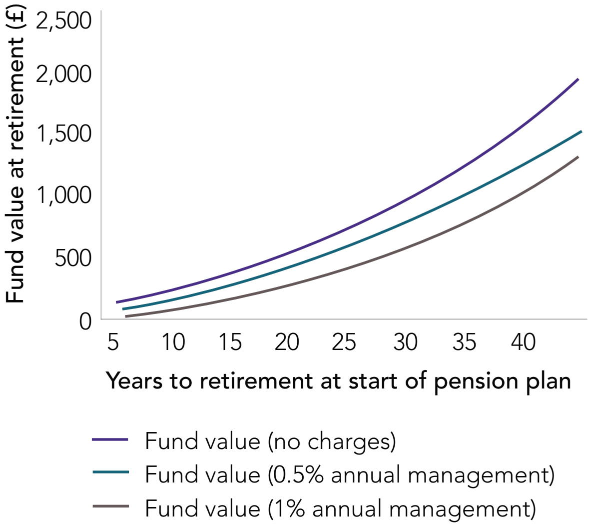
Take a look at the charge-related risks below.

High charges

Very high charges can have a major detrimental effect on a member's retirement fund if the investment return after charges are applied is poor. Where there is poor performance, this may discourage members from saving more into their scheme.

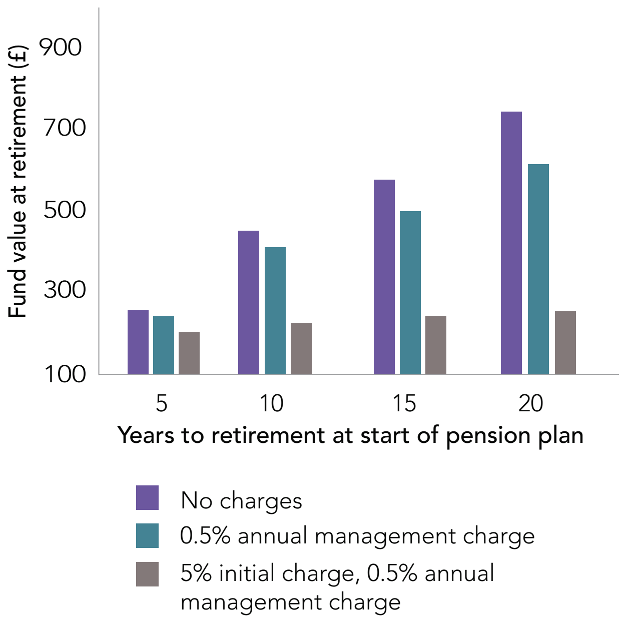
Impact of charges on a DC scheme

The graph shows the impact on the fund value at retirement of different levels of charges assuming a single investment of £100 is made and that investment returns are assumed to be 7% per year. If a member were to leave £100 invested over 45 years, with no management charges, the accumulated fund would be £2,000. The effect of a 1% annual management charge is to reduce that accumulated fund to approximately £1,350.



Upfront charges

With these types of arrangements, new joiners pay higher fees proportionately than longer term members. For example, a contribution charge may apply which is taken out of a member's contribution prior to investment. This may be flat rate or a percentage of the contribution. The level of the charges should be fair. Upfront charges were once a common feature in scheme design and the charges in legacy schemes in particular should be reviewed for VFM.



Impact of upfront charges on a DC scheme

The chart assumes an annual contribution of £100 for two years. The bars represent the value of the fund at retirement date relating to three contributions with different charging structures. The blue shows the effect of up front charges (ie a retirement fund of £275 after 20 years) and the purple has no charges (ie a retirement fund of £760). Many members drop out after two years of funding.

Flat rate charges

Trustees need to be conscious that long term members with small funds may suffer disproportionately if flat rate charges are applied.

As you saw in the question comparing charges, a flat rate charge of £40 for administration applied to a pot of £100,000 can seem quite small whereas it will seem large when applied to a pot of £1,000.

Hidden or non-publicised charges

It is good practice to ensure that members are warned about likely charges in advance. If, for example, members will incur a charge when they disinvest or switch funds it can affect their decision.

Mitigating the risk

Take a look below at two ways of mitigating the risk that members are affected by excessive charges.

You'll also find more information on this topic in the Tutorial: 'Member communications' later in this module.

Transparent charging structure

Both trustees and members need charges to be as transparent as possible. Having determined that a scheme is offering VFM, it is important that costs and charges are transparent to members.

Master trusts: As part of the authorisation, a statement of charges must be included in the master trust's continuity strategy which must be provided to TPR at the point of application, within 3 months of it being revised and at any time at TPR's request. See Code of Practice 15 at http://www.tpr.gov.uk/docs/code-15-authorisation-and-supervision-of-master-trusts.pdf.

Communicating with members

Trustees are expected to share clearly presented information about costs and charges with members throughout their membership of the scheme to enable them to make properly-informed decisions even if members appear to lack interest in finding out more about the scheme.

Where is this information available from?

Information about charges should be readily available from service providers including administrators, fund/investment managers, advisers etc. This information should include indirect charges which are not always obvious to the member as they may be taken from the member's fund by adjusting the price of units.

When are the key times members should receive this information?

The key times when members should be presented with information are:

- on joining
- annually (this will often occur in the members' benefit statement and in the annual chair's statement for those schemes required to produce one which must be made available to members)
- prior to members carrying out transactions that incur costs (for example switching funds)
- on request by the member
- on leaving the scheme/employer (especially if charges increase when a member becomes deferred)
- before charges or funds change

Answers

Comparing charges

Option three is correct. In Fund A, members one, two and three would pay charges of £12, £120 and £600 respectively over a one year period. In Fund B this changes to £40, £130 and £530.

Although the AMC in Fund B is lower, the additional flat rate charge disproportionately affects members with lower pot sizes. This means that member three is the only one to be better off in Fund B.

When comparing charges, it is important to compare 'like with like' and not focus on just one type of charge in isolation.