IMA RESPONSE TO DWP CONSULTATION

"*Better workplace pensions: Further measures for savers*"

May 2014

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IMA Response to DWP Consultation

The IMA[1] welcomes the Government's emphasis on enhanced governance and transparency. While we continue to believe that the charge cap is not the best route to ensure good member outcomes, we support the creation of Independent Governance Committees for contract-based schemes and the broader focus on better defining quality standards for Defined Contribution (DC) schemes. We agree that the investment and pensions industry needs to work towards greater transparency and consistency in its disclosure of charge and cost information, and are working to facilitate that objective.

A key concern of the IMA is that governance and disclosure standards risk being inconsistent as a result both of the different structures that exist for pension delivery, and the different regulatory authorities and approaches in the UK and the EU. We also believe that proposed changes announced in the Budget reinforce the need to avoid prescriptive regulation on DC scheme governance, which might quickly be superseded by the evolution of the public policy environment.

All of this points towards high level governance requirements in law, but a single set of quality standards that are developed and updated over time under the oversight of a pan-stakeholder group comprising Government, regulators, industry and schemes/consumers. A particular focus here should be default strategy design, given extensive evidence on scheme member behaviour internationally. In this area, we recommend a quality standards check that is both concise and actionable, and applicable both to contract and trust-based schemes.

Administration

1. **We would welcome views on the potential benefits of accreditation of administrators, and what role government and regulators could play in supporting this.**

2. **We would also welcome suggestions of other approaches to helping trustees and Independent Governance Committees (IGCs) ensure that their scheme is being administered to a good standard.**

Q1-2. We do not have specific views on this area.

Mastertrusts

3. **Should mastertrusts have to meet the same independence standards as providers of contract-based schemes?**

Yes. We believe that there needs to be consistency in a number of key areas across the DC environment, particularly given that from a scheme member perspective the service offered will be very similar. Independence needs to be clearly demonstrable. From the investment perspective, one critical aspect will be the need to justify manager selection for delivery of the default strategy.

[1] The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £4.5 trillion of assets in the UK on behalf of domestic and overseas investors.

This does not militate against the use of in-house investment management firms, but places the onus on managing potential conflicts of interest transparently.

4. We would welcome views on the proposed definition of 'independent' at Annex B.

This seems like a reasonable definition. However, the proposed minimum size of independent governance committees may complicate arrangements in this area. Will there be a sufficient pool of independent trustees who meet these criteria? A related consideration is that the Government should be mindful not to replace one potential risk with respect to the balance of member interests (not having IGCs) with another (concentrating decision-making in the hands of a comparatively small group of trustees who sit on multiple scheme governance committees or trustee boards).

5. Should the independence requirements be applied in different ways to different models of mastertrust. In particular, how should the independence requirements be applied to mastertrusts that use an independent trustee firm to act as their corporate trustee?

Our main comment on the issue of independent trustee firms is again the need to avoid concentration / lack of diversity risk within the decision-making structures of DC schemes. While it is difficult to identify a specific mechanism that can avoid this, it merits more discussion.

<u>Trust-based governance</u>

6. We would welcome views on the proposed quality standards for trust-based governance which are summarised at Annex B.

Our detailed comments focus particularly on investment governance and we have proposed a check list of quality standards for governance (for more detail, see Annex to this response). We would agree that the DWP best practice guidance does need to be overhauled, both to put core governance requirements on a firmer regulatory footing, and to take account of the changes being introduced in the Budget. Such core requirements should include provision of suitably diversified default investment arrangements and of clear communication and accountability mechanisms.

We also agree that setting detailed standards in regulation is not the optimal approach. Furthermore, consistent standards should be set for both trust-based and contract-based schemes. We observe that the proposals in the Command Paper appear to perpetuate what is perhaps an unavoidable regulatory split in responsibility, but not an unavoidable split in the establishment of standards for DC governance whatever the delivery structure.

The IMA has proposed the creation of a form of actionable quality standards for default investment arrangements that could operate under the auspices of a pan-stakeholder structure, including Government, regulators, industry and consumer / scheme representatives.

Such standards would be designed to offer a concise, practical way for all DC schemes to operate, avoiding potentially onerous regulatory or auditing requirements. While we have focused our proposals on default DC investment arrangements, such an approach could also extend to other aspects of DC operation.

The IMA is proposing an approach, which would provide:

- A *practical roadmap* to develop and implement default investment strategies, acting as a quality check for standards.

- A *'one stop shop'* that regulators could access to assess behaviour and ensure that requirements in both the contract- and trust-based environments are met.

- A *consistent document supplied by schemes to employers* who need to ensure that they are selecting a default arrangement that is fit for purpose when making scheme selections.

- *A procedure with the flexibility and capacity to evolve over time*, adapting to changes in the marketplace, including innovation in delivery.

The objective is to deliver a way to demonstrate a consistent quality of process in an environment where investment approaches and delivery architecture will continue to differ widely, but where the core governance questions remain constant. The announcements in the Budget have amply demonstrated why hardwiring DC quality requirements may be unwieldy.

7. Are the requirements listed at paragraph 8 the right quality standards to be set in regulations for trust-based schemes?

See answer to Q6 above.

8. Should trust-based schemes be required to have a chair of trustees?

Yes. From an organisational perspective, it is hard to imagine not having a chair.

9. Will the new reporting requirements help drive compliance with the standards and regulation of these?

While accountability mechanisms are essential, good governance is ultimately about behaviour. Great care needs to be taken in getting the balance right between influencing behaviour and creating a complicated and onerous culture where there is an undue focus on compliance, rather than energy focused on delivering what is judged best for scheme members. From an investment perspective, the IMA is trying to develop a framework that strikes this balance correctly, offering a set of core requirements as a starting point for behaviour, but providing flexibility in the way in which they are implemented and monitored.

<u>Transparency</u>

10. We would welcome views on how these transparency requirements could be made to work effectively in unbundled trust-based arrangements (including mastertrusts).

Transparency is not scheme or product specific. See our answer below.

11. We would welcome views on whether the transparency requirements we propose for DC schemes should, in the future, be extended to DB schemes, to enable sponsoring employers to further scrutinise the costs of such schemes.

From an investment perspective, the debate about transparency is not about DC schemes exclusively, but extends across the product and client range. The IMA believes that significant improvement is needed across the investment and pensions landscape and is working to facilitate that.

<u>Charge disclosure</u>

The methodologies and terminology for calculating and disclosing charges in all long-term savings and investment vehicles (including pensions) need to be more consistent. While much attention has focused on the charge cap and definition of the cap, the cap is in effect a compliance and not a disclosure issue. Members will still need to be told what they are paying in an accessible and consistent manner e.g. a combination of contribution charge and ongoing charge.

While pensions differ from investment funds, the IMA believes that the approach used in the UCITS Key Investor Information Document (KIID) offers a template for pension charge disclosure in its use of a single methodology and single terminology. The debate about differences between Annual Management Charge (AMC), Total Expense Ratio (TER), Additional Expenses etc.. has to move forward. For investment funds, the IMA issued its Enhanced Disclosure Guidance in 2012 and recommended that its members focus on the Ongoing Charges Figure (OCF) used in the KIID. Recently, we saw this FCA echo this stance. It is perfectly feasible to devise a methodology that would allow the emergence of an OCF for pension products, presented in combination (as applicable) with other forms of charge.

<u>Transaction costs</u>

Transaction costs need to be more readily available, expressed in a meaningful way, but – as rightly concluded by the Government – should not be part of the charges cap. We continue to make a distinction between the (predictable and reasonably comparable) charge levied for a professional service such as an investment or pension fund, and the (less predictable and less comparable) transaction costs incurred in delivering an investment return. While both need to be disclosed in a consistent manner, we do not believe that the case for bundling together in a single number has been made in a compelling manner by proponents of such an approach. On the contrary, it could be positively unhelpful, potentially preventing the accurate assessment of either charges or transaction costs. The Government has taken the correct decision in maintaining the distinction, as was also recommended by the DC Market Study conducted by The Office of Fair Trading.

The IMA is working to develop better metrics for transaction costs. Disclosure of explicit costs is already a regulatory requirement for investment funds. They are to be found in the annual fund report and accounts. [2] Our 2012 Enhanced Disclosure Guidance aimed to make these existing disclosures more accessible by recommending that a three-year average for aggregate transaction costs be published on firms' websites, accompanied by suitable narrative to aid an understanding of the significance of the figures.

More recently, we have led work on a revised Statement of Recommended Practice (SORP) for investment funds, which requires a simple summary in the report and accounts, in "pounds and pence per unit" terms, of the performance, the operating costs and the direct transaction costs for the year. In addition, the analysis of the transaction costs includes an indication of the bid/offer spread on the portfolio. The SORP approach could be used conceptually for other pooled vehicles, although the mechanisms for collecting and disclosing the data may be different, and more challenging in some areas of DC delivery.

Next steps include work on portfolio turnover rate methodology and the disclosure of implicit costs. We note the current intensive EU regulatory activity on transaction cost disclosure, and

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[2] The SORP for authorised funds requires disclosure of each type of transaction cost in the fund's accounts. Notwithstanding that the SORP offers recommended practice, compliance is a matter of regulatory compulsion.

encourage UK Government and regulators to adopt as joined up an approach as possible in this area.

However transaction costs metrics are developed, we need to be alert to the fact that there will be a diverse audience, and that scheme decision-makers and scheme members may well approach such metrics very differently. With respect to members, there is a clear risk of unintended consequences, whereby members may draw misleading conclusions about different elements of the capital markets – such as seeing one sector of the markets having lower associated transactions costs than others and making an investment decision on that basis. Disclosure requires carefully prepared, clear descriptions to accompany data.

ANNEX: AN IMA PROPOSAL FOR DC DEFAULT ARRANGEMENT GOVERNANCE

Government and regulators are asking for a clearer definition of what constitutes quality in DC pension provision. Focusing on the default investment strategy, the IMA is proposing an approach which would provide:

- A *practical roadmap* to develop and implement default investment strategies, acting as a standards quality check.
- A *'one stop shop'* that regulators could access to assess behaviour and ensure that requirements in both the contract- and trust-based environments are met.
- A *consistent document supplied to employers* who need to ensure that they are selecting a default arrangement that is fit for purpose when making scheme selections.
- *A procedure with the flexibility and capacity to evolve over time*, adapting to changes in the policy environment and marketplace, including innovation in delivery.[3]

The objective is to deliver a way to demonstrate a consistent quality of process in an environment where investment approaches and delivery architecture will continue to differ widely, but where the core governance questions can clearly be defined.

Key considerations

Developing a definition of quality in DC is challenging, particularly given the length of the pension saving process and the fact that outcomes will ultimately only be evident – and subject to final judgement – many years in the future. There are no universal 'right' answers on investment strategy, but there are processes that clearly need to be followed to ensure that members have the best possible chance of good outcomes in retirement. In this respect, demonstrable quality of process is absolutely critical.

Our quality check approach was developed prior to the OFT market study of the DC workplace pensions market. It could play a key role in satisfying OFT concerns about the need for a "minimum governance standard that will apply to all schemes."[4] We understand the pressures to use legislation to create standards around the governance of default investment arrangements, but we do not believe that this would be the most effective approach.

In common with the OFT and TPR, we are also concerned to ensure that we do not sleepwalk into a conflation of quality with lowest cost. Charges and costs must always be an important focus as part of the scheme governance process and are an important factor in our approach. However, the debate over quality of delivery must start with an expression of what this means for scheme design and scheme members, and how quality can be delivered in a cost-effective manner.

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[3] Much of the material in this short paper can also be found in our response to the DWP call for evidence last Summer. Our response focused in particular on the question of quality vs low cost, with an emphasis on investment governance standards in the default strategy. Alignment of interests between decision-makers and scheme members is not a sufficient condition for good outcomes.

[4] Office of Fair Trading, *Defined contribution workplace pension market study* (2013), p.24.

What would the quality check seek to achieve?

The check would take the form of a single document supplied to employers to help ensure that the scheme they use as part of their automatic enrolment duties is adequate. It would cover:

- Decision-making responsibilities, including management of conflicts of interest.
- The overall objective for the default strategy, including a requirement to ensure value for money in delivery of the strategy.
- Implementation and review of the strategy.
- Communication to scheme members.
- Safeguarding of assets.

Rather like an MOT, schemes that are not able to satisfy the requirements would not be allowed 'on the road'.

The document would be produced by pension schemes (both trust-based and contract-based) and their advisers, as applicable, in the form of a statement of default arrangement. We believe that it might be appropriate to make completion of a statement of default arrangement mandatory.

This approach would build on existing requirements, including DWP guidance, in a way to ensure 'one-stop' compliance and not create an additional burden for schemes. Indeed, the areas are already covered in a number of existing initiatives,[5] although no other document makes an attempt to amalgamate and summarise them in a consistent format in one place. While a Statement of Investment Principles (SIP) in the trust-based environment comes closest, the SIP approach can vary widely and is not a checklist of actions that should be undertaken.

Examples of this checklist approach can be found in professions such as aviation or medicine where highly qualified individuals are seen to benefit from what is essentially a behavioural support. Far from being the bureaucratic tool that some critics claim, it can be a valuable means to ensure consistency of process.[6]

> *"Aviation has required institutions to make discipline a norm. And we have national regulations to ensure that [National Transport Safety Board] recommendations are incorporated into usable checklists and reliably adopted…To be sure, checklists must not become ossified mandates that hinder rather than help. Even the simplest requires frequent revisitation and further refinement."*
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> (Atul Gawande, *The Checklist Manifesto*)

One of the advantages of what we are proposing is that it would bring together key required standards *in one place and in a consistent format.* It would apply to trust-based and contract-based schemes, and successful completion should ensure compliance with all existing requirements. To be successful, it should be a simplification, not an addition.

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[5] Principally, these are the DWP's default guidance, TPR DC code of practice and regulatory guidance and the IGG DC (best practice) principles.

[6] This is a point emphasised in a recent report by CASS Consulting / BNY Mellon, *Pension Scheme Governance in a Risk-Focused World*,. See in particular Atul Gawande, *The Checklist Manifesto*, 2011.

This quality check document also has a number of advantages over a purely legislative approach, as we outline below.

Features	**Default arrangement quality check**	**Legislative / regulatory approach to defining standards**
Practical roadmap to implement required standards in default provision, acting as a quality check not a best practice guide.	✓	x
Compatible with both contract- and trust-based arrangements.	✓	Not yet clear
Consistent, accessible document supplied to employers who need to ensure in making scheme selections that they are selecting a default arrangement that is fit for purpose.	✓	x
Tool for regulators who wish to assess and compare investment governance quality on a consistent basis across the whole pensions market.	✓	Not yet clear
Flexibility to evolve over time, adapting to changes in the marketplace, including innovation in delivery approaches.	✓	Not yet clear

Governance and development

The IMA has already undertaken preparatory work on a quality standards document and has been discussing it with stakeholders over the past twelve months. A number of points should be emphasised:

- This would not be an IMA document or process. We wish to table the concept of an accessible, actionable and consistent approach to default investment governance at a critical time for the development of DC schemes.

- Further development, including evolution over time, would be best achieved in partnership between Government, regulators, employers and pensions industry (including those representing the interests of scheme members).

- For the proposal to move forward requires acceptance from Government and regulators. In particular, we hope that it can become a central part of the DWP's current work on defining DC quality.

With millions of individuals being auto-enrolled into pensions in the next few years, it is imperative that quality can be defined in a way that builds confidence and trust in the delivery architecture, whether trust-based or contract-based. The IMA wishes to make a concrete contribution to bridging both the philosophical and regulatory divide in the UK in a way that can tangibly help employers fulfil their responsibilities and improve DC decision-making processes.