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20 August 2020

Dear Madaliso,

RE: IA response to the Call for Evidence on the Review of the Default Fund Charge Cap and Standardised Cost Disclosure

The Investment Association (IA) welcomes the opportunity to provide input to the DWP's call for evidence on the charge cap, ahead of the government's review. Investment is at the heart of DC pensions. Member outcomes are ultimately a function of the contributions paid in and the investment returns achieved on them. Lower investment returns over the long term imply a lower level of income in retirement or a higher level of contributions required to achieve a given income target. We therefore strongly emphasise the importance of ensuring that DC pension schemes can build investment portfolios capable of delivering the best outcomes for their members. The future of the charge cap is crucial in allowing DC schemes to operate effectively in this regard. Charges are clearly very important, but the starting point needs to be how a scheme delivers an effective investment strategy at a competitive cost.

We respond in detail to several of the consultation questions below. We have three key messages in our response:

1. The charge cap should be left at its existing level. It is not clear what policy problem a reduction in the cap is seeking to solve. The data cited by DWP in the Call for Evidence shows that on average, pricing has been well below the level of the cap[1] for a number of years, with the impact of the cap shown by the differences in charges for qualifying versus non-qualifying schemes[2].

[1] See paragraphs 32-35 of the Call for Evidence.
[2] See paragraphs 36-37 of the Call for Evidence.

Since these figures were based on a survey from 2016, we support the DWP's intention to collect further evidence on charges as part of the review process – and recommend that information on default strategy performance be collected alongside it – in order to allow for a full assessment of the health of the DC workplace pensions market. We would expect this work to confirm that average charges remain well below the cap, with the market continuing to compete strongly on price.

This is certainly the experience of investment managers as service providers to DC schemes: price competition in the DC workplace pensions market filters through to investment management services, with schemes incentivised to keep investment costs low and investment managers competing strongly on price, amongst other factors. This has resulted in a market in which investment strategies are built primarily to meet a cost constraint rather than with a member outcome in mind.

Indeed, the balance of risks of a reduction in the charge cap is towards DC investment solutions (and pension products) becoming commoditised, with low levels of innovation and concentration of providers and investment strategies, all of which will result in worse member outcomes.

The impact of a lower cap could have particularly adverse consequences for innovation in two specific areas of DC investment where the government is encouraging schemes to go further: Sustainable and Responsible Investment (SRI) and illiquid assets, where a lower cap will limit schemes' ability to invest in these asset classes.

In light of the clear risks to future member outcomes the charge cap should be left at its current level.

2. <u>Transaction costs should not be part of the cap.</u> Leaving the level of the cap at 75bps while bringing transaction costs into its' scope is a de facto lowering of the cap and will harm the investment process. Unlike the current design of the cap, which aims to constrain professional fees necessary for delivering investment, administration or communication in a pension scheme, this approach would impact the market costs necessary to deliver an investment return at all.

In this regard, capping transaction costs will not improve outcomes for members, and indeed is likely to make them worse, by hampering investment managers' ability to trade for the benefit of members, as well as creating operational challenges that will make the investment process less efficient for DC schemes. Furthermore, it would mean an additional element of cost within the cap, effectively shrinking the budget for existing services that must be paid for within the cap.

3. <u>The DC market should be fully transparent across costs, charges, and performance.</u>
Transparency of all costs in the pensions value chain, including investment charges and transaction costs, is vital to enabling trustees and IGCs to do their jobs and ensuring member confidence. The FCA's rules in COBS 19.8 and DWP and FCA duties on trustees and IGCs now mean that full transparency exists through the DC investment chain, from investment managers to scheme members, via DC pension schemes. In 2017, the IA and ABI worked together to create standardised templates that deliver the requirements of COBS 19.8 and these are now the industry standard for the provision of cost and charge data in the DC market.

Additional transparency is needed in two areas.

The first relates to a more granular disclosure of the costs of pension provision: investment performance is best judged net of the cost of its delivery, and not simply net of the additional services that form part of a bundled pension product – administration, communication and governance. For this reason, an additional step is necessary in the transparency process: the ability of scheme decision makers and governance bodies to be able to access where possible the cost (and delivery) of the investment component of a pension product separately – rather than a bundled product charge.

Considering the cost of investment separately from other costs in a pension product would allow for a better assessment of 'value for money' of investment as well as giving scheme decision makers the tools to assess whether they are satisfied with the investment budget within the total cost of the scheme.

The second area relates to default strategy performance: while regulatory activity has been focused on ensuring the disclosure of costs, we note that whether schemes present the performance of their default strategy in the annual Chair's statement is a matter of the trustees' discretion. We recommend that the risk-adjusted performance of a scheme's default strategy over the last three and five years should be a mandatory disclosure in the Chair's statement. This will provide greater accountability for DC investment design over a time period that is appropriate to a pension product and help scheme members answer the fundamental question of whether their scheme is delivering value for money.

We hope this response is helpful and would be delighted to discuss it further.

Yours Sincerely,

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THE INVESTMENT ASSOCIATION

Response to consultation

Review of the Default Fund Charge Cap and Standardised Cost Disclosure

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Chapter 2: Potential changes to transaction costs

Q1. What are the advantages or disadvantages of extending the cover of the charge cap to include some or all transaction costs?

The purpose of the charge cap is to protect the interests of automatically enrolled pension scheme members. Members' interests are best served by generating good net returns for an appropriate level of risk over the relevant timeframe. Trustees and pension providers design investment strategies within the budget constraint imposed by the cap or commercial decisions on scheme pricing. Investment managers are then selected to try and deliver performance in line with the strategy's investment objective. The scheme's investment managers are paid a management fee to deliver performance, with the level of the fee negotiated between scheme and manager, and consistent with the overall price point that the scheme is targeting. Unlike management fees, transaction costs arise due to the buying and selling of investments and are paid directly to market intermediaries (stockbrokers and market-makers) or to government in the form of stamp duty. Transaction costs are not capped because to do so would create incentives that are contrary to the interests of members.

To comply with the charge cap, a trustee/pension provider must be able to measure and control the capped charges and costs effectively. Administration charges are readily measurable and usually predictable because schemes can negotiate with their service providers – including, but not limited to investment managers – a level of fee that is consistent with the scheme being compliant with the cap (or the price that the scheme seeks to target if below the cap). A scheme's service providers in turn face competitive pressure to price attractively if they are to be selected and retained by the scheme to deliver the relevant service within the budget set by the scheme. We discuss these price dynamics in the DC investment market in more detail in the next section.

Transaction costs, on the other hand, are not predictable because they are determined primarily by the level of trading that takes place and this level is found in response to investment opportunities and market conditions as they arise. Whilst explicit transaction costs are readily measurable, implicit transaction costs can only be estimated because they are calculated by reference to market data that is not specific to the transaction. The FCA's slippage calculation systematically over or under-estimates the implicit cost of each transaction[3] and relies on the assumption that, with enough transactions, these 'overs' and 'unders' will broadly offset each other to leave a reasonable estimate of implicit transaction costs. However, since the introduction of slippage, it has been clear that certain investment and trading strategies, one directional market trends and specific one-off events affecting markets invalidate this assumption and give inaccurate transaction cost data. Without reliable and accurate transaction cost data, it would be extremely challenging to design an effective mechanism to cap those costs. Even if there were more precise data, it is not clear how a cap mechanism could capture costs that by their very nature (i.e. implicit) do not constitute a payment from one party to another.

Very importantly, when considering transaction costs, it is essential to understand the complex relationship they have with member outcomes. Transactions are necessary to build and manage a portfolio and transaction costs are necessarily incurred as part of transacting. Investment returns arise directly from the growth of the selected portfolio constituents. The magnitude of transaction costs <u>relative to the value traded</u> is indicative of the efficiency of implementing transactions. Ensuring such costs per trade are minimised is a core part of any firm's execution policies and sophisticated transaction cost analysis (TCA) techniques are used to monitor the effectiveness of such policies. Good investment decisions, efficiently implemented, deliver the best member outcomes in the form of investment returns.

In contrast, the transaction costs disclosed in accordance with FCA rules in COBS 19.8 are expressed <u>relative to the amount invested</u>. It is tempting, but misleading, to draw conclusions about transaction costs expressed in this way. Faced with disclosures setting out transaction costs of £600 for option A and £500 for option B, a likely conclusion is that option B is cheaper. However, looking behind these figures reveals the opposite could be true. It might be that option A incurred transaction costs of 3bps on £2m traded and option B incurred 5bps on £1m traded. Clearly option A's trading activity is considerably cheaper, but the investor would have been misled by being blind to the fact that option A traded twice as much. The impact on investment returns of this higher level of trading can be assessed only by reference to the growth of the resultant portfolio constituents. The effect of capping transaction costs would be to cap the amount of trading leading to a different portfolio with different returns.

The call for evidence highlights concerns that investment managers might artificially inflate transaction costs to shift other types of costs on to scheme members unfairly – the inference being that capping transaction costs would protect members from such practices. It is observed that there is no evidence of this occurring and the essential fact behind this observation is that there is no motive for investment managers to behave this way. Investment managers do not benefit or receive any proceeds from transaction costs. In public markets transaction costs are paid directly to government (stamp duty), stockbrokers (dealing commission), and market-makers (bid-offer spreads) as part of the settlement proceeds of each transaction. Since the introduction of FCA rules in COBS 19.8 at the start of 2018, there has been full transparency of transaction costs itemised in detail.

[3] The slippage cost methodology calculates transaction costs as the difference between the price at which a transaction was executed, and the price in the market when the order to transact was transmitted to a third-party (the arrival price). Therefore, for each transaction, slippage includes market movements unrelated to the transaction that occur between the arrival and execution times.

This ensures that all costs are correctly classified. Notwithstanding the lack of incentive for investment managers to mis-classify costs, it is simply not possible to do so under the regulation as it sets out exactly what each type of transaction cost is.

Q2. What would be the impact on scheme member returns/industry if some or all transaction costs were covered by the cap?

Fundamentally, transaction costs are in no way indicative of member outcomes. This can be seen in **Exhibit 1** which shows the relationship between transaction costs and returns, based on Morningstar data for European equity funds during 2018-19. It demonstrates that whilst transaction costs may be high or low, and returns may be high or low, there is no correlation or causation between the level of transaction costs and investment outcomes in terms of the returns delivered.

EXHIBIT 1: RETURNS V TRANSACTION COSTS FOR EUROPEAN EQUITY FUNDS

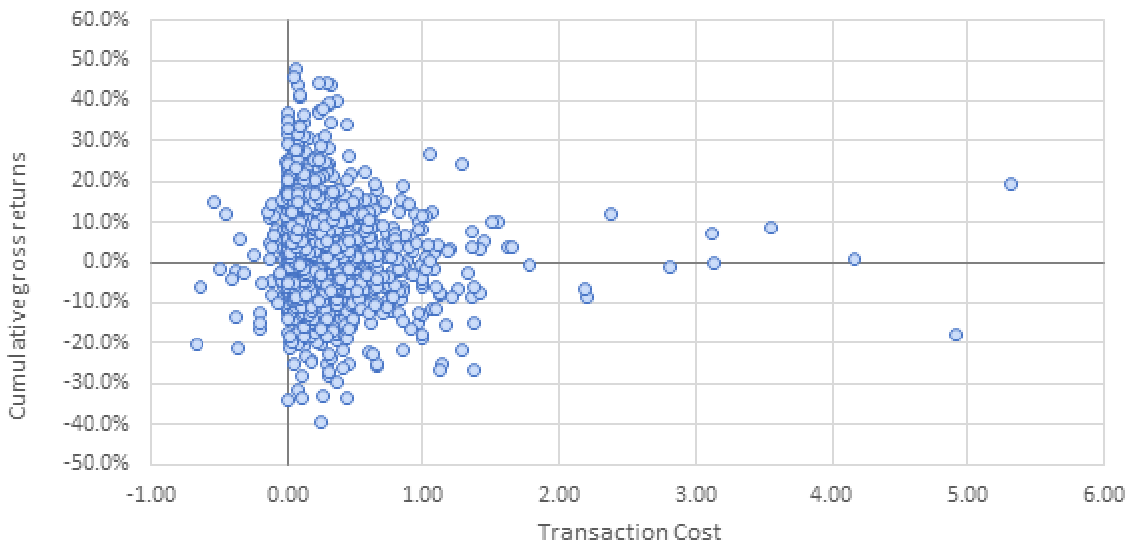


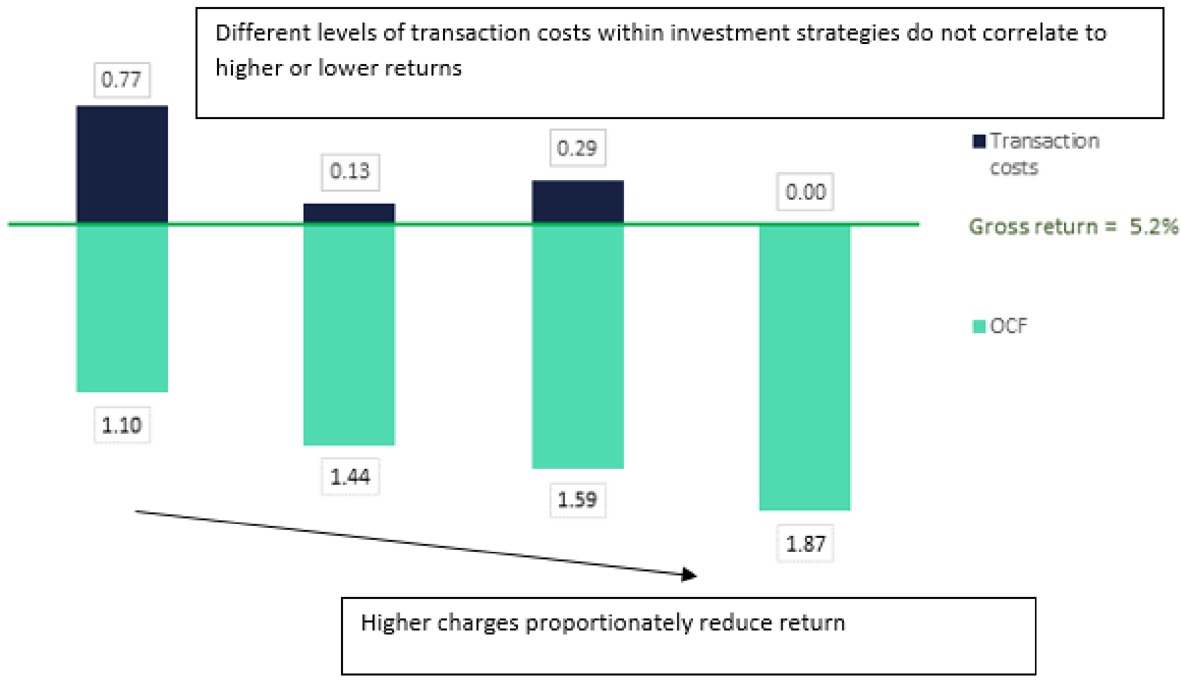
Exhibit 2 shows the returns (gross and net of fees), charges and transaction costs of four funds that have been selected from the sample illustrated in Exhibit 1. The four funds have been selected based on having delivered the same gross return to better demonstrate the differing effects of charges and transaction costs. The return after transaction costs is the relevant figure since it is the outcome of implementing the investment strategy employed by each fund – without incurring these transaction costs, there would have been no return.

Fund A has the highest transaction costs and aggregated total costs of 1.87% (ongoing charges plus transaction costs) but delivers the best return after fees. Conversely, Fund D has the lowest transaction costs and the same aggregated total costs of 1.87%. However, it delivers the worst return because it has the highest charges.

In our view, Fund D is unequivocally more expensive than Fund A because the higher charge has reduced the share of the return going to the scheme member. This indicates that capping transaction costs would do nothing to improve member outcomes.

EXHIBIT 2: EXAMPLES FROM EUROPEAN EQUITY FUNDS 2018-2019

	Transaction costs	Investment Return before charges (after transaction costs)	Ongoing charges	Cumulative (net) return[4] after charges
FUND A	0.77%	5.2%	1.10%	**3.2%**
FUND B	0.13%	5.2%	1.44%	**2.6%**
FUND C	0.29%	5.2%	1.59%	**2.3%**
FUND D	0.00%	5.2%	1.87%	**2.0%**



In conclusion, the evidence demonstrates that capping transaction costs will not cause member outcomes to improve and may cause them to deteriorate if asset managers' ability to trade is constrained. Specifically, actions undertaken with the sole intention of improving outcomes for members – for example, investing in less liquid asset classes (which generally have higher transaction costs); active security selection, active asset allocation; rebalancing – could end up being beyond the reach of most DC schemes.

<u>Operational challenges of capping transaction costs</u>

Beyond the theoretical arguments discussed above there are also some operational challenges of capping transaction costs, which will have adverse consequences for DC schemes and their members.

DC schemes are likely to be cashflow positive for many years, with strong inflows as new contributions are invested. This investment will incur transaction costs, and if these were

[4] All data is sourced from Morningstar. As the returns are cumulative and cover 21 months, the cumulative return + ongoing charges do not add back to the gross of fees return.

under the cap, would use up some of the budget within the cap, effectively lowering it. This will exacerbate the challenges that DC schemes already face in choosing where to allocate their costs, a point we discuss in detail in our answers to the questions in Chapter 3. For the DC investment market specifically, capping transaction costs will further limit the ability of trustees to build well diversified portfolios that are capable of delivering good member outcomes.

DC schemes mainly invest via pooled funds. A pooled fund consists of many different types of investor and one of the benefits of this arrangement is that investors in the fund benefit from the economies of scale achieved through the presence of other investors. Transaction costs to develop performance happen at the level of the fund: since the investment strategy is common to all fund investors, the transaction costs of the strategy are experienced by all investors[5]. It is not possible to cap transaction costs for only one type of investor. Therefore, if transaction costs were to be capped for DC schemes, firms would have to create a DC-specific range of funds which would have transaction costs capped at a specified level (and hence limits on the fund manager's ability to trade in members' interests). This would increase costs for DC schemes as they would lose the benefits of economies of scale of being in a pooled fund with other investor types. It is also the case that a fund level transaction cost limit would not suit all schemes, as they will have different budgets under the cap. This further undermines the efficiency of pooled vehicles for DC schemes.

Q3. Should there be a combined transaction cost and charge cap, or should these be separate?

For the reasons set out in our answers to questions 1 and 2, we do not think it is appropriate to cap transaction costs in any form.

Q4. Who should be responsible for complying with a transaction cost cap?

For the reasons set out in our answers to questions 1 and 2, we do not think it is appropriate to cap transaction costs in any form.

Notwithstanding this, it is also important to highlight that there is a fundamental challenge here between who controls transaction costs and who is responsible for the default strategy, reflecting how most DC defaults are constructed.

Most DC defaults rely on multiple funds as building blocks in a strategy, in which for each fund, the fund manager incurs transaction costs to develop performance. The actions of each fund manager are independent from the others and they are not responsible for the transaction costs incurred in the other funds. For the purposes of capping transaction costs this is immediately problematic because it is transaction costs at a strategy level that is what matters. It is trustees and providers that design the overall default strategy and are responsible for compliance with the cap in its' current form, but they have no control over transaction costs. Therefore, no party can control transaction costs at the strategy level and hence it is impossible to make any one entity responsible for compliance.

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[5] This is the case for ongoing investors in a fund. Incoming or outgoing investors pay the transaction costs of their investment or disinvestment as a result of pricing mechanisms employed by the fund to protect the ongoing investors from the transaction costs incurred by those investing or disinvesting (a process known as dilution).

We therefore do not see how it is possible for large parts of the market to even comply with a requirement to cap transaction costs.

Chapter 3: The level of the charge cap

Q5. If we lowered the cap, what would be the impact on (a) scheme member outcomes (b) industry?

<u>The impact of lowering the cap on scheme member outcomes</u>

Charges need to be judged relative to investment outcomes and the quality of other services received by the member as part of the pension product. Focusing on charges in isolation is not a proxy for value. And while all else remaining equal, a lower charge will lead to a greater net return for scheme members, there are good reasons to believe that this may not be the outcome that many scheme members experience.

For one, with average scheme pricing considerably below the cap, members may see no change to their charges if the charge they currently pay is below the level of the new cap. For scheme members in this position a lower charge cap may be irrelevant in the short term, though it will likely result in lower levels of competition and innovation in future.

For members who are in schemes paying a charge above the level of the new cap, charges will need to come down. Where this is done with no changes made to the investment strategy or other elements of the service proposition (administration, member communications, and governance) the member will be better off.

However, this status quo scenario is unlikely to be the one that prevails. Providers who have to cut the charge to be compliant with the new cap are likely to cut costs in order to do so: by moving to a cheaper investment strategy or reducing the level of service provided in other areas. The impacts on the member here are ambiguous: a cheaper investment strategy may or may not result in a worse outcome, but lower quality of service provision in other areas is unlikely to be to the member's benefit. This underscores the need for a decision on the charge cap that is based on the value for money that pension products provide, not just the fees paid for them.

We comment in detail on the impacts on DC investment strategies in our response to Q6, but in summary, the impact of a lower cap is likely to be a restriction in the variety of asset classes and management styles that schemes can access on their members' behalf. This will lead to schemes being forced to construct less diversified portfolios that are solely reliant on the public markets, with the possible result of lower returns and more volatile member outcomes.

<u>The impact of lowering the cap on the pensions and investment management industries</u>

In the DC workplace pensions market, investment management activity is carried out by a broader range of parties than investment managers: default investment strategies are for the most part constructed by trustees and pension providers, on the advice of investment consultants and, where available, in-house investment teams. This process involves the setting of investment objectives for the default strategy and then deciding on strategic asset allocation, followed by a manager selection exercise to pick the managers that manage the strategy or components of it. This is mainly done via an investment platform that allows a scheme to combine multiple funds and managers into an overall strategy.

Schemes also have the option of outsourcing the entire investment process, including asset allocation decisions, to investment managers in products such as Target Date Funds, but the most common approach in DC is for schemes to design strategies that rely on multiple building block funds, with managers chosen to manage a particular asset class or strategy where they have expertise.

Within the budget constraint of the cap, or the level of charge that the scheme wishes to target, trustees and providers must design an appropriate investment strategy consistent with their investment beliefs and objectives. The process involves choices over the allocation of investments across asset classes and management styles, conducting significant due diligence of investment managers through the manager selection process, including robust negotiations on fees.

This is a market of professional buyers of investment services, who are incentivised to keep fees low out of competitive pressure and, in the case of trustees, their fiduciary duty to members. The idea that the cap needs to come down to protect pension savers is not consistent with market dynamics and the resulting incentives faced by providers.

We are concerned that the cap has already driven a focus on cost rather than what is the optimal investment strategy to implement a given member objective: there is a reluctance on the part of trustees and pension providers to spend more on investment strategy, even where there is a good investment case for doing so and there is headroom within the cap. The danger of a lower cap is that it removes investment choice for those schemes wanting it and risks further exacerbating the lack of focus on designing optimal DC investment strategies.

The DC market is highly competitive, both at the level of pension providers and investment managers. Reducing the cap will inevitably lead some providers and investment managers to exit the market if they are unwilling or unable to serve the market at prices at or below the new level of the cap. With a large pool of other potential clients, firms may choose to look elsewhere since serving one market segment may come with the opportunity cost of not being able to serve other segments of the market.

We see this particularly with private market investment strategies, where fee levels and structures (the use of performance fees is common) make these products challenging for DC schemes to access, but demand from other investors such as DB schemes and insurers means that there is little incentive for managers of these strategies to offer more DC-friendly price points and fee structures. The result is DC schemes are unable to access such strategies where they want to. This is an existing problem, albeit one that might be eased by the increasing scale of the DC market, but a lower cap would serve to exacerbate it.

For DC schemes seeking to access investment services, a lower cap will therefore result in fewer investment managers serving the market and a restricted choice set consisting of asset classes and markets that are highly liquid and relatively cheap to access, with management largely done on an index-tracking basis. This may have a number of consequences:

- Increased exposure to market returns and reduced diversification of asset classes – the combined impact of which will be to see DC savers exposed to more market volatility than other types of investors that have the option of making use of a greater variety of asset classes and risk management tools.

- Lack of access to particular asset classes or investment strategies may result in a lower-returning portfolio. This will result in worse member outcomes or a higher level of contributions required to maintain a desired level of income in retirement.

- With fewer investment managers in the market, the reduced competition will result in less choice and innovation.

We illustrate the first point with some data on the performance of several Diversified Growth Funds (DGFs) used in the DC market today, in comparison with equity market returns for Q1 2020. DGFs are multi-asset funds that seek to deliver returns similar to investing in growth-seeking assets, but at lower levels of volatility. A comparison with equity markets provides an indication of the impact of having a more diversified portfolio. In periods of strong equity market performance, market indices would be expected to outperform DGFs and vice versa. Exhibit 3 shows that these DGFs have indeed performed better than several major equity market indices during a period of significant market volatility.

EXHIBIT 3: Q1 2020 PERFORMANCE OF SELECTED DGFs AND EQUITY INDICES

EQUITIES		DGFs*	
FTSE All Share	-25.1%	**DGF 1**	-13%
FTSE All World	-19.7%	**DGF 2**	-12%
FTSE North America	-19.6%	**DGF 3**	-4%
FTSE Europe Ex UK	-21.5%	**DGF 4**	-4%
FTSE Japan	-17.2%	**DGF 5**	0%
FTSE Asia Pacific Ex Japan	-18%		
FTSE Emerging	-20.2%		

Source: Hymans Robertson.

*DGF returns are gross-of-fees

This is not intended to be an endorsement of any investment approach or provider (indeed, we have anonymised the fund names to avoid any such impression) but simply to make the point that schemes unable to build more diversified portfolios as a result of the cap will see their members more exposed to market volatility. This underscores the need to allow schemes to design optimal portfolios within a price point they are comfortable with, not one that is arbitrarily imposed on them.

The same logic applies also at the provider level: greater price pressure leads to firm exits, less competition and innovation. Depending on how low pricing goes the sustainability of some existing business written by providers may become questionable.

As part of its evidence gathering the government should therefore assess the impact of a lower cap on competition and innovation in the DC market – both at the provider level and at the level of service providers to schemes, including, but not limited to, investment managers.

Q6. How have investment approaches altered as a result of the introduction of the cap? What changes have there been in asset allocation, management style (active, passive, factor based)

Investment managers invest the contributions of DC scheme members in a variety of different asset classes in the UK and around the world. These investments contribute to economic growth, which in turn generates the returns that help grow members' pension pots. We would encourage government to recognise the wider capital allocation function of the investment management industry, including the reality that index tracking depends upon active allocation decisions across financial markets by investment managers and others.

Accordingly, active management should be viewed broadly to include active asset allocation and portfolio construction, access to a wide range of asset classes, risk management techniques and security selection. Of course, this does not mean that the entire budget must be spent and as schemes choose to spend less on investment, the options on offer to them narrow until the cheapest end of the DC investment market is reached – index tracking funds in highly liquid developed markets.

Schemes typically make use of a variety of products and strategies, incorporating both active management and index tracking. For example, an active asset allocation strategy can and often does use index tracking funds as building blocks to provide exposure to different asset classes. Equally, some asset classes may not be accessible via an index exposure. This is a common demonstration of how DC schemes face a choice between how best to combine active management and index tracking rather than picking one over the other. The IA offers no view on the suitability of particular investment strategies or products – these are decisions for pension schemes to make and it is right that they have a range of choice to suit their budget.

In the fully bundled segment of the market, a product fee in the range identified by DWP's survey evidence – around 40-55bps – leaves schemes with challenging decisions as to which elements of the service proposition they wish to allocate more of their costs to. Scheme administration is a relatively fixed cost and the consequence of this appears to be that investment costs are being squeezed more by the cap relative to other services, particularly since it is straightforward for schemes to switch to cheaper investment products. In this segment of the market, 10-20bps appears to be the size of the investment budget[6], with the following trends apparent in DC default strategy investment design[7]:

- Most providers tend to employ a de-risking approach whereby members move out of equities and into bonds and other diversifiers as they approach retirement. The degree of this shift is dependent upon the assumed retirement choice: drawdown, annuity, or cash. The first will see a lower level of de-risking as there will continue to be an exposure to growth-seeking assets in retirement. In contrast, the latter two options will see complete shifts to fixed income and cash or cash-like assets.

- As a result, many DC schemes are heavily invested in equities in the growth phase of their strategy, with multi-asset and fixed income approaches used in the later

[6] Master Trusts – Investment Designs: a comprehensive study, DCIF, 2017. Some master trusts report investment costs as low as 4bps.

[7] See: 'How to analyse workplace pension default funds', Defaqto, 2020 and 'Who's performing well? DC Default Fund Survey Q3 2019', Punter Southall Aspire, 2019.

part of the savings phase as retirement approaches. The time-period over which these shifts in asset allocation take place (the glidepath) varies across providers and is a function of the starting allocation of equities – with a higher initial allocation implying a longer glidepath – and the method of accessing income in retirement.

- Index-tracking is the main way that DC schemes gain exposure to markets, with active management far less commonly used.

- Other than property, there is little in the way of allocation to alternative asset classes such as early-stage equity and infrastructure that are accessed by other institutional investors to provide return and diversification benefits, particularly as members age.

- Providers with in-house investment management arms tend to have more sophisticated and diversified default offerings – likely to be a function of the greater internal resources available to such providers via the investment management arm.

A dominance of allocation to equities in the growth phase of DC investment is not surprising in and of itself – this is consistent with investment theory and the time horizon of DC savers, which together imply that a significant allocation to equities is expected to deliver an appropriate risk-adjusted outcome for members. The choice between active management and index tracking or combinations of the two within the asset allocation decision comes down to the investment beliefs and objectives of trustees and providers as well as cost budgets in light of the charge cap. Indeed, the investment budgets set by schemes often leave little room for any approach other than index tracking.

One implication of index investing being the most common investment approach in DC is that scheme members are fully exposed to market returns. While some scheme decision-makers may be comfortable with this, others may prefer a different route to risk management, including the use of active strategies and greater use of alternative asset classes as diversifiers in a portfolio. The danger of a lower cap is that decision-makers are no longer able to consider approaches that are optimal from their perspective, but only those that are allowed for in government policy. Anecdotally, this is not a comfortable position for many schemes. It is not without risk for government, regulators, and industry over the longer term.

The logical conclusion of these trends is that there will be a point where the investment element can be squeezed no further and DC product offerings will have to shed other elements of member-value added service. These will be difficult decisions for DC trustees and product providers. Maintaining the cap at the existing level will avoid the need for such difficult trade-offs and permit the increased use of a wider range of asset classes and investment strategies.

We now discuss two specific themes within DC investment where the future of the charge cap will have significant implications for the construction of DC schemes' portfolios.

<u>Responsible Investment</u>

The Government has taken significant action in recent years on responsible and sustainable investment in the UK pensions sector, introducing, amongst other things, new requirements on DC trustees to set out their investment policies on financially material

Environmental, Social and Governance (ESG) factors, as well as how these policies are implemented. The proposals set out in the current Pension Schemes Bill[8] requiring schemes to ensure that there is effective governance of the scheme's assets with respect to the effects of climate change will further intensify the responsible investment focus amongst DC schemes. Investment managers have in turn responded to the increased demand from DC schemes for responsible investment products, with the industry adopting a new IA framework providing categories and standard definitions to help customers[9].

In the process of integrating climate or broader sustainability considerations, DC schemes are likely to see a cost impact on different aspects of their investment strategy, such as portfolio management, index license fees, ongoing transaction costs and potentially transition costs to implement a new strategy. Some sustainable and climate investment opportunities e.g. renewable energy or other infrastructure may simply be priced out of schemes' budgets, particularly where these are in the private markets (see below) and cannot be accessed via an index, requiring instead a more intensive and specialised management process.

Although we see significant evidence in the market of highly competitive pricing on funds with responsible investment objectives, we are concerned that a reduction in the charge cap may limit DC schemes in their ability to focus on these issues at precisely the point that the Government is expecting more of them. As we highlight further below, it is essential that the debate on investment starts in the right place, with decision-makers looking at how they can deliver the best outcomes at the most competitive cost, not the other way around, where cost alone dominates the investment debate.

Illiquid assets

The other big theme in DC investment in recent years has been around incorporating illiquid assets into DC default strategies. There may be both return benefits – in the form of an illiquidity premium – and greater portfolio diversification and lower volatility, through lower correlation with other asset classes and more stable valuations.

The government has over the last year been clear in its desire to see DC schemes invest more in illiquid assets in general and infrastructure in particular. There is no shortage of DC capital and a need to improve infrastructure in the UK. Wider pressure on public finances also raises the prospect of less public expenditure on infrastructure, with a need for private capital to step in. Furthermore, the economic impact of the Covid 19 pandemic has resulted in a strong need for long term equity capital (particularly for SMEs and early-stage growth companies) to help boost the UK's economic recovery and the Bank of England has recently noted[10] that DC schemes could do more to provide such patient capital. The government is therefore right to ask the question of why DC schemes do not invest in infrastructure and other illiquid assets and the IA supports DC schemes' ability to make allocations to investment in this area, alongside other alternative asset classes.

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[8] As set out in clause 124 of the Bill, which at the time of writing, is currently awaiting its second reading in the House of Commons.
[9] The framework is available at https://www.theia.org/sites/default/files/2019-11/20191118-iaresponsibleinvestmentframework.pdf
[10] 'Protecting economic muscle: Finance and the Covid crisis' – speech on 23 July 2020 by Alex Brazier, Executive Director, Financial Stability, Strategy and Risk. Available at https://www.bankofengland.co.uk/speech/2020/alex-brazier-keynote-dialogue-at-the-cfo-agenda

We have done significant work on illiquid investments in DC, in particular from the perspective of the appropriate fund structures for accessing illiquid assets, and last year published a report[11] setting out a recommendation for a new fund structure that should facilitate greater access to illiquid assets by DC schemes. We have also engaged thoroughly with the FCA's consultation on the 'permitted links' rules[12], which are the crucial factor in determining what DC schemes can invest in when doing so through unit-linked life policies. The new rules have specifically expanded the range of investment options to include less liquid assets such as unlisted equity or infrastructure.

Including illiquid assets in the daily priced and traded environment that characterises DC default strategies is a complex challenge that requires governance time on the part of pension schemes and significant expertise from and co-ordination between investment managers and platforms. Notwithstanding the product structuring and distribution challenges in this area, it is possible to incorporate an illiquid allocation into DC defaults, and at the more sophisticated end of the DC market, this is starting to happen[13].

However, one major constraint on DC schemes' ability to access illiquid assets is cost. Illiquid strategies cover a broad range of asset classes, but the common feature to all of them is that they are on private, rather than public markets, and management of these assets is resource intensive, requiring significant research and due diligence when completing transactions. Naturally, such a management style comes with a higher cost. The charge cap already makes it difficult for DC schemes to invest in these asset classes because of the limited investment budgets available and the difficulty with incorporating performance fees (see below) – which are commonly used in the private markets – within the cap. Lowering the cap will only make the challenge of incorporating illiquids in DC schemes harder, if not impossible, and is inconsistent with the Government's policy goals in respect of DC schemes' ability to access illiquid assets.

The Government recognises in the call for evidence that the decision on the cap is a *"difficult balance between minimising industry burdens, protecting scheme member interests and enabling long-term capital allocation[14]".* Leaving the cap at its current level and not expanding its scope to include transaction costs is the best way of achieving this balance.

Performance fees under the charge cap

While the call for evidence does not seek views on performance fees directly, they remain relevant in any discussion of illiquid assets under the charge cap because their use is so common in these asset classes. Performance fees can strengthen the alignment of interests between investment managers and investors. Since they only arise where a manager has

[11] 'IA UK Funds Regime Working Group: Final Report to HM Treasury Asset Management Taskforce', The Investment Association, 2019. Available to download at https://www.theia.org/sites/default/files/2020-04/20200330-ukfrwgfinalreport.pdf. See the discussion in Chapter 1 and Annex 1 on the Long-Term Asset Fund.
[12] IA response to FCA CP18/40 Consultation on proposed amendment of COBS 21.3 permitted links rules. Available to download at https://www.theia.org/sites/default/files/2019-04/IA_response_to_FCA_CP18-40_permitted_links_280219.pdf
[13] Schemes such as NEST, USS and JP Morgan have taken the lead in incorporating private markets into their default strategies. Further interest in illiquids is now apparent in the master trust market. See for example, 'Master trusts: weathering the market's highs and lows', DCIF, 2020.
[14] Paragraph 13 of the Call for Evidence.

delivered outperformance for the investor, capping them is perverse, since it penalises a scheme for having benefitted from outperformance.

Some DC schemes have expressed a desire to use them but have felt prevented from doing so by the cap, even though the cap does not prohibit their use. Notwithstanding the Government's consultation last year on proposed additions to the method of assessing compliance with the charge cap where performance fees are used, it is likely that they will remain infrequently used in DC. Their use is incompatible with providing trustees and pension providers with complete certainty that the scheme is compliant with the cap. This naturally makes trustees reluctant to use them, even if they would like to.

A better approach would be to exclude performance fees from the cap altogether and leave it to schemes to negotiate the appropriate arrangements with their investment managers. This may allow DC schemes greater possibilities in allocating to illiquid assets, for example through innovative fee structures that involve low base fees which are capped, alongside uncapped performance fees. Such a fee structure is likely to create a stronger incentive for a manager to deliver outperformance for the scheme, while being more flexible to suit DC schemes' investment budget.

The details should be left to schemes to negotiate. We repeat the point that DC schemes are professional buyers of investment services and should be able to negotiate with service providers without having their hands tied by regulation. Appropriate member protection is provided by the fiduciary duty of trustees to members, the strong investment governance processes required by TPR and full transparency of costs and charges that trustees and their investment managers must comply with. Together these ensure that trustees must demonstrate why and how scheme investments are delivering value for money for members and this will include consideration of the charging structures used.

The danger of the current situation – which would only be exacerbated by a lowering of the cap – is that schemes may simply be unable to allocate to asset classes where performance fees are common.

Q7. Have schemes changed administrator or asset manager in response to the cap?

We are aware of several instances where schemes have changed asset managers or strategies purely on grounds of cost. While changing scheme administrator may be a more complex process, changing to a new pooled fund is straightforward, particularly on the investment platforms that many schemes use to invest.

The reality is that if the primary goal of the pension scheme is to minimise costs, then switching investments is the most efficient way of helping to achieve this goal, due to the ease of switching and the fact that very low-cost investment products are available on the market. Decisions made on such grounds are reflective of the view that exists in some parts of the market in which schemes perceive price to be their biggest risk. Lowering the cap can only exacerbate this kind of behavioural response, further creating a regulatory equivalence between quality and low cost.

Q8. What links have you found between cost and performance?

All pension provision has a core set of costs and charges: the investment process which generates returns, as well as administration, communication, and governance (including professional advice, as appropriate). Depending on the nature of the scheme, DB or DC, contract-based or trust-based, single employer or multi-employer, the configuration and hence the cost base will vary.

Performance, defined in terms of the returns delivered to savers, can only be generated through investing contributions. In a bundled pension scheme, where all fees are contained within the product charges borne by members, that investment return will be reduced proportionately to those fees. The question from a customer perspective would be whether those fees have translated into a better service – better performance obviously, but also for example, a user-friendly website or responsive call centre.

From a pure investment perspective, the FCA Asset Management Market Study reiterated findings about performance that have been made elsewhere over many years, namely "there is no clear link between price and performance" at the level of individual fund fees. However, FCA data in the Market Study also showed that actively managed equity funds delivered higher returns over the period studied (2003-2015) than their benchmarks[15]. This suggests that the answer as to how best to invest lies not in a focus purely on cost, but on the objectives, investment process and outcomes in the context of the costs.

Effective investment governance is key to delivering good outcomes for DC members[16]. In an environment where outcomes are not guaranteed, a good investment governance process can enhance the likelihood of good member outcomes. This starts with the definition of a member-led investment objective and the design of an appropriate investment strategy to achieve that objective. Continuous monitoring of performance, fees and on-going suitability of the strategy is required.

A greater focus on default strategy performance over an appropriate time period across the DC market more generally will help the auto enrolled population. Performance, along with contributions, is ultimately what drives member outcomes. As we have explained in our answer to Q5, default strategies are largely designed by trustees and pension providers in conjunction with their advisers. In these arrangements asset managers are accountable for the performance of their component funds, but it is trustees and pension providers that are accountable for the performance of the default strategy as a whole.

Currently, commercial DC providers compete largely on price, a dynamic the government has strengthened by signalling to trustees the need to focus primarily on charges and costs – an example of this being the requirement on trustees to publish default strategy charges and transaction costs, with no corresponding requirement to publish default strategy performance[17]. Surprisingly in this context, performance publication is left to the discretion of trustees. In order to help drive value for money for members, the government should require trustees to publish information on the risk-adjusted performance of the default

[15] This finding is discussed at length in the IA's response (2017) to the FCA Asset Management Market Study Interim Report, available to download at https://www.theia.org/sites/default/files/2019-05/IA_response_to_FCA_Market_Study_Interim_Report.pdf See in particular Part 2, section 4 and Annex One, section 5.
[16] The IA discussed investment governance and default strategy design considerations in a position paper published in June 2018: 'Putting investment at the heart of DC pensions'. Available to download from https://www.theia.org/sites/default/files/2019-05/20180621-puttinginvestmentattheheartofdcpensions.pdf
[17] The Occupational Pension Schemes (Administration and Disclosure) (Amendment) Regulations 2018

strategy[18] over the last three and five years in the annual chair's statement alongside charges and transaction cost information.

Three- and five-year periods represent an appropriate time period over which to properly judge default strategy performance. This period also aligns well with the required triennial review of the default strategy. While annual performance is useful to disclose as a means of accountability to members, it should not be given undue emphasis, as it is less relevant for the long-term horizon of pension savers and their ultimate retirement goals.

While there is no single right answer in DC investment, a focus on investment strategy design and performance across the market – aided by the scrutiny of external commentators – can help trustees and providers learn from best practice in other schemes. Greater scrutiny on investment strategy and performance will help shift the investment focus of schemes away from a view narrowly through the lens of price and on to delivering the best possible member outcomes within the investment budget available.

We draw here a comparison to DB investment, whereby trustees are responsible for delivering an outcome – ensuring the scheme meets its benefit obligations. Cost is of course important, but it is not the overriding factor and there has been significant investment innovation[19] to help trustees better manage their risk and meet their obligations. Were cost to be the main determinant of a DB scheme's investment strategy, the DB landscape would look very different – risk management would disappear and portfolios would be less diversified, with more volatile funding outcomes and lower levels of benefit security the result. Yet, the logic of outcomes being secondary to cost is deemed reasonable in DC investment. DC scheme members deserve the same focus on their investments as DB members.

Finally, as a practical matter in the current review of the charge cap, we do not see how this can be effective without information on the performance of DC default strategies – a focus on price that ignores the outcomes delivered risks not coming to a balanced conclusion. Any justification for a lower charge cap must be grounded in evidence that outcomes from DC default pension products were consistently poor across the market in relation to the fees charged. As part of its review of the Government should therefore seek information from pension schemes on net-of-charges default strategy performance over the period of the charge cap being in place and consider this alongside the data it will be gathering on scheme charges.

Q9. How much notice should be given for any reduction in the cap?
As discussed at length in answers to questions 5 and 6 we do not believe that the cap should be lowered at all. However, if a decision is taken to lower it then schemes and the investment management industry must be given as much time as possible to respond, since they may need to take a number of actions in response.

[18] Performance should be shown for different age cohorts of members – reflecting age-related differences in asset allocation that are typical in DC default strategies.
[19] For example, the development of Liability Driven Investment (LDI) and Cash-flow Driven Investment (CDI) strategies, which are designed to help trustees better manage their funding risks and cash flow needs, respectively. The DB market has also seen strong growth in Fiduciary Management arrangements, which allow trustees to delegate the day to day management of their portfolio to a Fiduciary Manager, enabling scheme investment decision making to be more dynamic.

Investment managers will need to re-consider their product offerings and consult with their pension scheme clients on how to re-position their portfolios in light of a lower cap. Where schemes need to change investment strategy, they will incur transaction costs in doing so. Where a scheme holds illiquid assets, the very nature of these means it takes longer to sell them and a short-term exit may be impossible. Schemes should therefore have a significant period of time to transition to a new portfolio in order to avoid any unnecessary loss of value during the transition.

Chapter 5: Standardised cost disclosure templates

Q14. Is legislative intervention required to support uptake of the CTI templates?

We see no reason to further intervene in the DC market as full cost and charge transparency is already available using standardised templates that are recognised as the industry standard in the market. These are in turn supported by legislative duties on trustees and IGCs to assess the information they receive and on investment managers to provide the information that pension providers need.

In 2015 legislation came into effect introducing the charge cap and placing a duty on trustees and IGCs to assess transaction costs. The FCA's Asset Management Market Study Final Report (June 2017) noted that, although it had been difficult for pension trustees to get information on transaction costs, they were in the process of consulting on mandatory standardised disclosure of charges and transaction costs to trustees and IGCs and consequently that they "*do not consider further remedies are needed to make transaction costs transparent to trustees.*" These disclosure rules (set out in the FCA's PS17/20 and now in the FCA rulebook in COBS 19.8) came into effect in January 2018 and placed an obligation on asset managers to provide DC schemes with all the information on charges and transaction costs they need to monitor charge cap compliance and to assess transaction costs.

During 2017 the ABI, on behalf of pension providers, and the IA, on behalf of investment managers established a joint working group to produce a standardised framework to deliver in full the requirements of the FCA's rules in COBS 19.8. This framework[20] was launched in December 2017, just prior to the rules coming into force, and provides all the data necessary to allow DC pension providers to calculate the charges and transaction costs of their solutions. This framework is established as the industry wide standard for DC transparency.

In the DB market, since the start of 2018, investment managers have been required by MiFID to provide their clients with information on all costs and charges and to provide an itemised breakdown at the request of the client. The FCA commented in the Asset Management Market Study Final Report (June 2017) that *"irrespective of the use of any standardised template, the requirements of MiFID II mean that firms should provide accurate information on costs and charges, and inaccurate information, whether or not provided within a template, would be a breach of the MiFID II rules, against which we could take supervisory or enforcement action."* The CTI framework provides a standardised format for an itemised breakdown that, although not mandatory, is closely linked to the mandatory requirements of MiFID II. The framework was launched in May 2019 with the

[20] The templates and associated documentation are available at https://www.theia.org/industry-policy/guidelines/data-delivery-frameworks . See the dedicated section on DC workplace pensions.

recommendation that the templates should be used for the first time for pension schemes' financial years ending December 2019 and March/April 2020. Anecdotally, it appears that uptake of the templates is high amongst asset managers. We would suggest it is still too soon to assess the uptake and use of the data provided by DB scheme trustees.

Q15. How easy is it to request cost information from asset managers?

This question is best answered by pension schemes, but we note that investment managers have regulatory obligations under COBS 19.8 (in respect of DC workplace pension schemes) and MiFID II (in respect of investment management services provided to DB schemes) to provide pension schemes with cost and charges information. We are not aware of any problems that investment managers are having in producing the data in line with these requirements.

Q16. Do you believe that scheme members and recognised trade unions should have the right to request the information provided on the CTI template, and that a requirement to disclose this on request is proportionate?

This is ultimately a matter for pension schemes as it relates to their data.

Q17. Should DB schemes be required to adhere to the same standards?

It is not entirely clear to which standards the call for evidence is referring, but we note that in any case this is a matter for pension schemes.

As service providers, investment managers are already required by MiFID to provide their clients with information on all costs and charges and to provide an itemised breakdown at the request of the client and it is now common practice to provide this breakdown using the CTI framework.

Q18. What are the barriers to using the information obtained when making decisions?

This question is best answered by pension schemes and their advisers.