THE INVESTMENT ASSOCIATION

David Eaton
Department for Work and Pensions
DC Policy Team, Policy Group
Private Pensions & Arms Lengths Bodies Directorate
Zone A, 3rd Floor South
Quarry House
Quarry Hill
Leeds LS2 7UA
pensions.investment@dwp.gov.uk

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

+44 20 7831 0898
imran.razvi@theia.org
mark.sherwin@theia.org
theia.org
@InvAssoc @The Investment Association

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Dear David,

RE: IA response to 'Improving outcomes for members of defined contribution pension schemes'

The Investment Association (IA) welcomes the opportunity to respond to the DWP's consultation on improving outcomes for DC pension scheme members. We continue to emphasise the importance of ensuring that DC schemes are able to build fully diversified portfolios in order to realise their members' financial goals. This is a core part of ensuring value is delivered for DC pension scheme members.

We respond in detail to a number of the consultation questions, but we are overall very supportive of the DWP's proposals, particularly with regards to the mandatory reporting of investment performance for all DC schemes and the assessment of a scheme's investment governance process as part of the value for members assessment for smaller schemes. It is, however, disappointing that DWP has stepped back from the proposal to make it easier for trustees to monitor their compliance with the charge cap where performance fees are used. The selection of investments should be based on investment fundamentals and not skewed on the basis of the type of charging structure a particular investment has put in place.

We recommend incorporating investment risk into the investment performance assessment and are cautious about making direct comparisons of value across schemes, particularly in relation to investment performance and costs, given different investment strategies and services provided to members: value should instead be judged against intended outcomes. On the whole, we feel the package of measures here will lead to better outcomes for members by bringing more transparency and scrutiny to DC investment strategy design, and placing investment at the heart of DC provision.

Although there are no measures specifically on illiquid assets, we note the DWP's comments around wishing to see DC schemes make greater allocations to illiquids. We support the ability of trustees to make these allocations if they believe the investment case justifies it at an acceptable cost to the scheme. To that end, we have been working over the last 18 months on ensuring that investment managers are able to offer illiquid assets through the pooled funds that DC schemes most commonly invest through.

The DWP is correct to note that fund structures such as the Qualified Investor Scheme (QIS) and investment trusts already exist as options for accessing illiquids and that the FCA's recent changes to the permitted links rules for unit-linked life funds have expanded the scope for accessing illiquids through life funds. However, the experience of investment managers is that DC schemes want an alternative fund vehicle: one suitable for retail investors (which platforms are more comfortable with) and whose net asset value (NAV) directly reflects the value of the underlying assets, thus providing true illiquid exposure, which is not always true of listed investment trusts. Meanwhile, issues with the permitted links rules remain, notably the 35% cap on a life fund's holdings of illiquid assets.

We are currently working on all these issues with the FCA. We have proposed a new fund structure – the Long-Term Asset Fund (LTAF)[1] – that should facilitate greater access to illiquid assets by DC schemes through a retail vehicle. The new vehicle is designed to have a broader range of investment powers and liquidity management tools that are better suited to holding illiquid assets. It is also intended to be a permitted link and thus suitable for holding within a life structure. We look forward to progressing this work in the coming months with the intention that investment managers should be able to offer access to illiquids via an LTAF ideally by the end of 2021.

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

Yours Sincerely,

Imran Razvi
Senior Policy Adviser
Pensions & Institutional Market

Mark Sherwin
Senior Policy Adviser
Financial Reporting

[1] '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.

THE INVESTMENT ASSOCIATION

Response to selected consultation questions

Improving outcomes for members of defined contribution pension schemes

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: Encouraging Consolidation

Q1. We would welcome your views on the reporting of net returns – how many past years of net returns figures should be taken into consideration and reported on to give an effective indication of past fund performance?

We have been calling for a number of years for default strategy performance to be a mandatory disclosure for workplace DC schemes and we therefore strongly support the DWP's proposals on net performance reporting for all DC schemes. This will provide greater accountability for DC investment design and help scheme members answer the fundamental question of whether their scheme is delivering value for money.

However, when assessing investment performance, it is important to also consider the risk taken to achieve that performance. By not considering the risk of an investment strategy any assessment of what it has delivered can only be partial. Two investment strategies may deliver the same outcome, but one that does so at a lower level of risk would be judged to have delivered a better experience for the member. **We therefore recommend that the requirement be to report risk-adjusted net performance as well as headline performance.** There are a number of ways of measuring the risk of an investment portfolio and it can be left to the discretion of trustees to choose appropriate metrics. As an example of one possible approach, we highlight the risk-adjusted performance disclosures that NEST makes available to members in its quarterly investment report[2].

While annual performance is useful to disclose as a means of annual 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. **A three-year period would represent the minimum timeframe over which to properly judge performance** of the default strategy and other funds available to members. This period also aligns well with the

[2] NEST Quarterly Investment Report - Q2 2020. Available to download at https://www.nestpensions.org.uk/schemeweb/dam/nestlibrary/Nest-quarterly-investment-report.pdf

required triennial review of the default strategy. A five-year period[3] would be even more appropriate, although perhaps aligns less well with the requirement to review the default strategy every three years.

Finally, since asset allocation varies over time in DC, reflecting changes in the strategy's risk profile as members age, **risk-adjusted net performance should be shown for different age cohorts of members**. Five-year cohorts may be a typical cohort size, but we suggest leaving the precise size of the age cohorts to the discretion of trustees, in recognition of the diversity in age-related asset allocations that may be pursued across schemes.

Q2. Do you think that the amending regulations achieve the policy aims of encouraging smaller schemes to consolidate into larger schemes when they do not present optimal value for members?

Yes, we agree that the regulations meet the policy aim of encouraging smaller schemes to consolidate where they do not provide value for money, since the regulations require trustees to carry out an extended value for members assessment and state where they do not believe that value for members is being delivered. This process is likely to put pressure on trustees to consolidate the scheme if it is not delivering value for members.

We agree that the regulations set out the key factors trustees must consider when making a value for members assessment: net returns, charges and costs and administration and governance. As per our answer to the previous question, we recommend that the reference to net returns (investment performance) be changed to 'risk-adjusted net returns' in order to clarify that investment risk form a part of the assessment of investment performance.

In order to assist trustees with both their overall value for money assessments as well as the new value for members assessment for smaller schemes, there may be a role for an independent body to deliver peer group rankings for DC default strategies, based on the levels of risk, style of fund, and age to retirement, along with other rankings for those in-retirement. This would be similar to fund classifications that already exist for authorised funds, such as the IA sectors[4]. The DWP and TPR could work with relevant pensions industry bodies to encourage the development of such a classification system for the DC market.

We support the wider set of criteria that are proposed for consideration as part of the assessment of administration and governance. On investment in particular, it is important to consider the wider investment governance process in the value for members assessment, as this is an important feature for maximising the chances of a good outcome for members. Specifying the quality of investment governance and assessing on-going suitability of the default strategy as factors to be assessed on administration and governance is therefore a welcome move.

However, we do not agree that trustees should be required to directly compare investment performance and charges and costs to other schemes. Value for members is best assessed in relation to what a scheme delivers to its members. Focusing on the combination of

[3] Ideally, the disclosure of longer performance periods alongside the headline three- or five-year performance numbers would be helpful where the information exists. UCITS funds, for example, must report 10 years of past performance where the data exists.
[4] https://www.theia.org/industry-data/fund-sectors

charges and costs, risk-adjusted net performance and administration and governance provides all the information necessary to assess the scheme in the context of overall costs and delivery. This is what is most important to members.

It is of course important for trustees to understand developments in product design and cost across the market, as this provides a way of understanding where their scheme sits in relation to other schemes on the market. However, a formal comparison of schemes is more challenging. It is neither practical, nor necessarily helpful to start comparing components between schemes which are likely to be highly bespoke, whether in the area of administration (e.g. nature of service, number of active members etc.), communication (e.g. nature of member engagement process) or investment, where mandates can differ widely according to providers' investment beliefs and the budgets they allocate to investment. Therefore, a formal comparison with other schemes should not form part of a value for members assessment.

Q3. Do you believe that the statutory guidance increases clarity about the minimum expectations on assessing and reporting on value for members for specified schemes? Are there any areas where further clarity might be required?

The guidance generally provides useful clarity for trustees with respect to the new value for member reporting requirements. Beyond our overarching comment about the challenges of cross-scheme comparisons (which apply equally to the relevant sections of the guidance) we have a number of comments on a few specific areas:

- Charges and transaction costs should be shown separately rather than on an aggregated basis (as displayed in the table at paragraph 45 of the guidance). Adding them together provides a misleading number because they are fundamentally different in their connection to returns: product charges are paid for the service delivered and higher charges clearly reduce net returns. In contrast, transaction costs are incurred in the market in order to deliver a return and do not behave in the same way as charges: higher transaction costs do not necessarily imply anything about the level of the overall investment return. Importantly, the gross return achieved already includes transaction costs. Adding charges and costs together is misleading and reduces the transparency of reporting.

- Transaction costs should only be reported in the context of the returns they deliver. In isolation they provide little information, both within and across schemes. Two different sets of transaction costs will represent two entirely different sets of investment return and a simple comparison will be misleading e.g. one scheme may pursue an active strategy while another may choose to track an index. The former strategy is likely to have higher transaction costs driven by higher levels of trading: but without comparing the returns delivered, a simple comparison will be misleading and will in any case not be on a like-for-like basis.

We have included a detailed discussion on the relationship between transaction costs and returns in our recent response[5] to the DWP's call for evidence on the default strategy charge cap. This provides more detail on the above points and we do not repeat them here, but instead refer the reader to pages 3-6 of that response for further information.

[5] IA response to the DWP call for evidence on the review of the DC default fund charge cap and standardised cost disclosure. Available to download at https://www.theia.org/sites/default/files/2020-08/IA%20response%20DC%20charge%20cap%20review%20200820_1.pdf

- At paragraphs 55-56, the guidance states that more expensive strategies are likely to be poor value for money unless performance is markedly better. This neglects the impact of risk management in DC schemes: a more diversified strategy may deliver a below-market return in times of rising markets but may provide more downside protection when markets are falling. This underscores the need for trustees to focus on risk-adjusted returns when assessing performance.

- The discussion in paragraphs 66-68 on comparing investment returns across schemes is problematic because it takes a simple view that a better-than-average performing scheme delivers better value than a worse-than-average performing scheme. This ignores the fact that outcomes may be different because schemes follow different investment strategies whose objectives and cost may be different. Simply comparing one set of returns to another does not allow a judgement to be made that a better performing scheme delivers better value to one that performs worse: particularly when past performance is not a guide to the future. This underscores the need to focus on a scheme's own investment performance in the context of the investment objective it is seeking to deliver, the risk taken and the investment beliefs and governance process that resulted in the chosen investment strategy.

- The guidance is helpful on the factors that should be considered when assessing the quality of investment governance and as well as the ongoing suitability of the default strategy. Our only comment here is that the list of factors under investment governance could also include matters of asset security: trustees should understand how secure members' assets are, what risks there may be to them in the event of any of the scheme's relevant service providers becoming insolvent, and what recourse/protections members may have in case of any such event.

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

An in-year adjustment to pro-rating performance fees

Q4. Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?

Overall, we are disappointed that DWP has stepped back from the proposed additional method of assessing compliance with the charge cap where performance fees are used. The selection of investments to form part of a well-diversified portfolio should be based on the investment's fundamentals, including consideration of the overall level of charges taken from the members' pot, and should not be skewed on the basis of the type of charging structure particular investments have put in place.

On the specific consultation question, the draft regulations do achieve the intended easement. We agree with this easement only being available where the performance fee is always accrued within the value of the investment concerned.

In our opinion, limiting the easement to a single charge structure is unnecessarily restrictive and it should also be available in respect of an existing rights charge in a combination charge structure. The argument against this is that it would make the charging structure too complex. In reality, both single charge and combination charge structures are already a complex aggregation of all the cost items laid out in Annex F of the current consultation document (this list covers more than 20 broad types of costs many of which are further sub-divided in to individual cost items), but this complexity is not exposed to scheme members. A performance fee embedded in an existing rights charge in a combination charge structure would appear no more complex than a performance fee embedded in a single charge structure. Therefore, in order to ensure all schemes have access to the same range of investments regardless of their charging structures, the easement should also be available in respect of an existing rights charge in a combination charge structure.

The nature of the proposed amendment is to provide relief from an existing requirement and is not capable of triggering a breach of the charge cap. Therefore, we see no reason to delay the application date beyond the date on which the amendments are made, and no reason why it cannot become applicable during a charges year.

Creating a multi-year rolling calculation approach (Qs 5-8)

We have no comments in response to questions 5 to 8.

Costs of holding physical assets

Q9. Do the draft regulations achieve the policy intent? Do you have any comment on the definitions used?

We welcome the proposal to put the exclusion of the costs of holding physical assets from the charge cap on a statutory footing for the additional certainty this provides. We note the proposed physical assets definition is widely cast but that the list of costs in paragraph 1A of the draft regulations appears to be drafted with real estate in mind. We regard the list as adequate in the context of real estate but would recommend considering broader references to costs relevant to other types of physical assets. For example, point (a) could also refer to costs of operating the asset.

The nature of the update is to change the statutory basis of the existing exclusion, so we see no reason to delay the application date beyond the date on which the update is made.

We note the list of costs solely attributable to holding physical assets for exclusion from the charge cap in Annex F. This guidance does no more than replicate the text of the draft regulations. We recommend expanding this list by using the more granular examples set out in paragraph 68 of the consultation document and supplementing this with some examples of costs relating to physical assets other than real estate.

We are surprised by the proposal in paragraph 75 of the consultation document which “propose[s] that schemes should look through all open-ended funds and all UK listed closed-ended investment funds and international equivalents” as it would appear to exclude the unlisted cohort of closed-ended funds. The revised drafting of the list of costs in Annex F (investment costs: ongoing charges for underlying funds …) also seems to exclude these unlisted funds as well as open-ended funds other than UCITS, NURS or QIS.

In our opinion the list of costs would be clearer and less ambiguous if it referred to the substance of the underlying funds rather than their form. In this respect we reiterate the recommendation in our response[6] to the previous consultation:

"Ongoing charges for underlying investment products in investment portfolio, e.g. fee for holding units or shares in collective investment schemes, investment trusts or similar vehicles."

The inclusion of capital gains tax to the second point under the heading "Transaction costs" is incorrect because capital gains tax is not a transaction cost unrelated as it is to the buying or selling of investments – it arises on profits made as a result of changes in the value of an investment and should be listed under the heading "Taxes" in Annex F.

The first point under the heading "Other exclusions" is limited to classification under the UK listing rules and we recommend, as a minimum, expanding this point to include international equivalents. Our preferred approach would be to revert to the original approach consulted on, which referred to the concept of a general commercial or industrial purpose. This is drawn from guidance[7] relating to the identification of collective investment undertakings and distinguishes between, for example, REITs that are construction companies and REITs that are investment vehicles.

Chapters 5-6, Questions 10-13:

We have no comments in response to questions 10 to 13.

[6] IA response to DWP consultation on 'Investment innovation and future consolidation', p10. Available to download at https://www.theia.org/sites/default/files/2019-04/IA_response_to_DWP_investment_innovation_CP_March_2019.pdf

[7] ESMA Guidelines on key concepts of the AIFMD, p3. Available to download at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-611_guidelines_on_key_concepts_of_the_aifmd_-_en.pdf