THE INVESTMENT ASSOCIATION

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Dear Sir/Madam,

RE: IA response to CP20/9 Driving value for money in pensions

The Investment Association (IA) welcomes the opportunity to respond to the FCA's consultation on driving value for money in pensions. The competitive dynamics in the DC workplace pensions market have hitherto been largely focused on price, resulting in a market where low cost is often conflated with value for money. In that regard, an enhanced focus on value for money may be helpful.

We respond to several of the consultation questions below and have a number of views on the proposed rules:

1. Price, investment performance and quality of service are appropriate components of value for money. On investment in particular, as well as performance and risk, it is important to consider the wider investment governance process in the value for money assessment, as this is an important feature for maximising the chances of a good outcome for members. We therefore support the proposals to explicitly incorporate into the value for money assessment the existing requirements to assess the objectives and execution of the default investment strategy as well as its on-going suitability for members.

2. Value for money is best assessed in relation to what is delivered to relevant policyholders in a provider's own scheme. Understanding developments in the products offered and relevant costs across a market is also important, as the consultation notes, but the way the consultation frames the question does not offers a clear practical pathway for IGCs. The draft rules refer to a focus on the *combination* (our emphasis) of the charges and costs when "compared with other comparable options". This implies a scheme or default strategy level assessment and should be feasible in the context of overall costs and overall delivery. 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.

3. <u>Charges and transaction costs should not be viewed in isolation within and across schemes.</u> When comparing scheme charges it is important to consider the services received in return and not the charges alone.

Additionally, giving IGCs the ability to access where possible the cost (and delivery) of the investment component of a pension product separately – rather than a bundled product charge – would allow for a better assessment of value for money of investment as well as giving IGCs the tools to assess whether they believe their provider has set an appropriate investment budget within the total cost of the product.

When assessing transaction costs, it is essential to understand their relationship with investment returns, which ultimately feed through to member outcomes. Transactions are necessary to build and manage a portfolio and transaction costs are necessarily incurred as part of transacting. These costs may be high or low but considering them in isolation provides no indication as to whether they represent value for money. They should be viewed only in relation to the investment strategy and the returns delivered.

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

Yours Sincerely,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

Response to consultation questions
CP20/09 Driving value for money in pensions

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.

Q1. Do you agree with our 3 proposed elements for assessing value for money? If not, what alternative factors do you suggest?

We agree that these are the main elements of a value for money assessment.

However, we would add that 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. There are a number of ways of measuring the risk of an investment portfolio and it can be left to the discretion of IGCs to choose appropriate metrics.

We acknowledge that the FCA recognises the importance of assessing the investment risk profile of default strategies in its discussion in paragraph 4.25 of the CP. However, we think it should be clear in the rules that investment risk must form part of the assessment of investment performance.

We therefore suggest amending the rules to state that the value for money assessment should cover “risk-adjusted investment performance”. This modification should cover all references to investment performance in the draft rules.

As well as performance and risk, it is important to consider the wider investment governance process in the value for money assessment, as this is an important feature for maximising the chances of a good outcome for members. We therefore support the amended rules which explicitly incorporate into the value for money assessment the existing requirements to assess the objectives and execution of the default investment strategy as well as its on-going suitability for members.

Q2. Do you agree with our proposed Handbook guidance about the meaning of value for money? If not, what alternative wording would you suggest?

Q3. Do you agree with our proposed process for VfM assessment? If not, what alternative process would you suggest?

Combined answer to Qs 2 and 3

Value for money is best assessed in relation to what a provider's own scheme delivers to its policyholders. Focusing on the combination of charges and costs, performance and service quality provides the information necessary to assess a provider's scheme in the context of overall costs and delivery. This is what is most important to policyholders.

It is important for IGCs to understand developments in product design and cost across the market, as this provides a way of understanding where a provider's offering sits in relation to other products 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 money assessment.

Q4. Do you agree with our proposals for IGCs to consider whether any of the comparable schemes assessed offer lower administration charges and transaction costs? If not, how should IGCs review costs and charges?

Care needs to be taken when comparing charges and transaction costs across schemes. A simple comparison of charges and costs without wider context will lead to incorrect conclusions.

Administration charges
Administration charges are paid for the service delivered as part of a bundled pension product – investment performance, member communications, governance etc. and should be viewed in relation to the quality of those services. When comparing charges across schemes it is important to consider the services received in return.

In addition, as part of the focus on charges, more granular disclosure of the costs of pension provision is needed for IGCs to assess value for money. 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 IGCs 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 IGCs the tools to assess whether they believe their provider has set an appropriate investment budget within the total cost of the product.

Transaction costs
Transaction costs are different in nature to administration charges. They 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.

Very importantly, when considering transaction costs, it is essential to understand the relationship they have with investment returns. 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 relative to the value traded is indicative of the efficiency of implementing transactions. Ensuring such costs per trade are minimised is a core part of any investment manager'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 investment returns that help drive good member outcomes.

In contrast, the transaction costs disclosed in accordance with FCA rules in COBS 19.8 are expressed relative to the amount invested. It is tempting, but misleading, to draw conclusions about transaction costs expressed in this way. Faced with disclosures setting out transaction costs of £6m for scheme A and £5m for scheme B, a likely conclusion is that scheme B is cheaper. However, looking behind these figures reveals the opposite could be true. It might be that scheme A incurred transaction costs of 3bps on £200m traded and scheme B incurred 5bps on £100m traded. Clearly scheme A's trading activity is considerably cheaper, but the investor would have been misled by being blind to the fact that scheme 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.

Transaction costs should therefore never be assessed in isolation but in relation to the investment portfolio and the returns delivered. This is the case both within and across schemes.

Q5. Do you agree with our proposed guidance that fully complying with the charge cap does not necessarily indicate value for money?

Yes, we agree, because concluding that compliance with the charge cap indicates value for money ignores the quality of services delivered and creates a false equivalence between regulatory compliance and value for money.

Q6. Do you agree that a reasonable comparison of costs and charges with other options available on the market will put pressure on high-charging providers to reduce their changes and transaction costs? If not, how else could this outcome be achieved?

There is already heavy pressure on providers to lower prices, with price the main point of competition in the workplace pensions market, both at the level of pension providers and investment managers. In that regard these rules are likely to reinforce existing trends.

Q7. Do you think that further guidance will improve the assessment of legacy products?

This question is best answered by pension providers.

Q8. Do you think that our proposed rules and guidance will improve the clarity of IGC annual reports?

Yes, we agree that the proposed rules and guidance will provide further clarity for readers of the IGC annual reports on whether a provider's schemes represent value for money and how that assessment has been reached.

Q9. Do you think that firms providing pension products should have a specific responsibility on ensuring the VfM to customers of these products?

This question is best answered by pension providers, although since value for money is to some extent a subjective judgement, it may be difficult for pension providers to meet this standard in practice.