THE INVESTMENT ASSOCIATION

Lisa Leveridge – The Pensions Regulator
Cosmo Gibson – FCA
By email: **VFMdiscussionpaper@tpr.gov.uk**
/ **VFMdiscussionpaper@fca.org.uk**

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL
+44 20 7831 0898
imran.razvi@theia.org
theia.org
@InvAssoc @The Investment Association

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Dear Lisa and Cosmo,

RE: Investment Association Response to DP21/3 'Driving Value for Money in DC pensions'

The Investment Association[1] (IA) welcomes the opportunity to respond to the FCA/TPR joint discussion paper on driving value for money in DC pensions. The competitive dynamics in significant parts of the DC pensions market have in recent years been increasingly focused on price, resulting in a market where low cost is often conflated with value for money. An attempt to shift the focus of the market towards value is welcome.

In this regard, we are supportive of some the key approaches set out in the discussion paper, notably:

Appropriate return metrics

Disclosure of risk-adjusted net returns over an appropriate time period is important in providing accountability for the member experience in a DC pension. Net returns are the outcome of the investment decisions taken and implemented by pension schemes and their investment managers, and the scheme's overall cost base. These should be subject to scrutiny. The goal of DC pension saving is to generate a good outcome in retirement: the net return achieved represents the most important part of the scheme member's experience on the path to that goal and should therefore be a core part of assessing value for money.

[1] 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 members range from small, independent UK firms to Europe-wide and global players. Collectively, they manage over £9.4trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. That is 13% of the £75 trillion global assets under management.

<u>Value of investment services</u>

The value for money of investment should be judged primarily in relation to the cost of delivering the scheme's investment strategy and not in relation to the costs of other services incurred as part of a bundled pension product, which represent a further drag on member return. We therefore support the disclosure of a scheme's investment costs separately from the other costs of bundled pension provision. This additional piece of transparency will better enable DC governance bodies to assess the value for money of investment and consider whether the investment budget in their schemes is appropriate for what the scheme is seeking to deliver.

This links to an important point, which we discuss further below in relation to more challenging areas, with unintended consequences. **Investment performance is not the same as member return**, which is the result of investment performance net of all delivery costs (investment management, administration, governance, communication etc..).

<u>Market-wide metrics</u>

Understandably, schemes may wish to use different comparators to understand both their cost base and delivery. The challenge with **market-wide benchmarks that seek to compare schemes is that they may not provide meaningful information for decision-making because they are not like for like.** There are two reasons for this:

- Overall member return (as opposed to investment performance) is driven by multiple different factors, not just investment performance and costs.

- At a more granular level, it may not be straightforward to compare 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.

Value for members may therefore best be assessed in relation to what an individual scheme delivers to its set of members. We would therefore encourage regulators to reconsider what they are seeking to achieve with their benchmarking exercises. The focus on investment performance is understandable, and the investment management industry is one of the most measured industries in the world. However, the paper suggests that it is not investment performance in isolation that is the focus, rather it is member return. How that should be broken down and measured requires careful consideration. We would propose as a starting point that the terminology is changed to start with member return and then to consider the appropriate metrics for measuring investment performance level alongside the drag on that return that is the result of different costs, some of which are substantial and unrelated to investment.

<u>Scope of reforms</u>

Finally, we recommend that **any measures in this area do not apply to the non-workplace pensions market**. The markets for workplace and non-workplace pensions are very different in nature. Automatic enrolment has created a rationale for an additional focus on workplace pension products and the problem of value and low cost being conflated – which is precisely what the regulators are seeking to solve – has been a feature of the workplace segment of the DC market. The additional disclosures highlighted in the discussion paper are complex, aimed at pension professionals, and notwithstanding our concerns highlighted here, intended to lead to a greater focus on value in workplace pension products.

In contrast, the disproportionate focus on cost seen in workplace pensions has not been the concern in the non-workplace pensions market. In the absence of automatic enrolment, non-workplace customers are, by definition, more informed; they may also use advisers when accessing these products. Advisers and other distributors act to apply competitive pressure in the non-workplace market driving value for money, rather than simply lower charges. While requiring providers to make the additional disclosures discussed in the paper would increase costs, it is not clear what benefit they would have for non-workplace customers. Indeed, there is scope for significant unintended consequences if the market wide benchmarks are introduced to a target audience that may not be sufficiently engaged and / or knowledgeable to understand the rationale for why particular schemes may differ from the market norms.

I hope this response is useful and I would be happy to discuss these comments further if helpful.

Yours Sincerely,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

DP21/3: Driving value for money in DC pensions
Response to selected consultation questions

<u>Investment performance</u>

Q1. Do you agree that consistent disclosure of performance is necessary and could enable better decision making?

Yes, we agree. Customer outcomes in DC pensions are entirely a function of the contributions invested and the returns achieved on them, net of all costs incurred in delivering the pension (investment, administration, communication, governance etc.). Investment is therefore at the heart of delivering good outcomes for customers and the disclosure of investment performance over an appropriate time period is critical to assessing the value of DC products.

Performance disclosures also serve as a measure of accountability for the decisions taken in creating the investment strategy. Good performance over a prolonged period represents a vindication of those investment decisions, while the persistence of poor long-term performance would be evidence that those decisions were not having the desired outcome, and that a change in approach may be necessary.

Q2: Do you agree that comparisons should be of net rather than gross investment performance?

Q3. Do you have any suggestions on how to make disclosure of net investment returns effective given that there may be varying charges for the same funds within multi-employer schemes? For example, displaying a range, or requiring disclosure of each different level of net investment performance.

<u>Combined answers to Qs 2 and 3</u>

Return disclosures should be on a net-of-fees basis since this reflects the realised experience of the customer. This should be net of fees at the overall strategy level rather than the component fund level.

In the case of multi-employer workplace schemes, where different customers face a different charge for the same investment strategy, the net-returns figure disclosed should reflect the charge paid by the customer. IGCs and trustees considering the scheme level charges for different employers will need to see a range of charges here.

Q4. Would it be helpful to mirror the DWP's approach in terms of the reporting periods?

Yes, we agree with the proposal to align performance reporting periods with the DWP's approach. 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. We consider that a five-year period for the assessment of performance is a minimum, and the reporting of longer-term performance where this track record exists will be helpful.

It is important to contextualise long term performance as well, since the longer the period in question the more likely it becomes that a material change has taken place, such as change of investment objective or investment adviser, which could affect the assessment of the investment performance delivered.

Q5. Would publishing a set of metrics based on age cohorts bring investment performance reporting closer to the saver's investment performance experience of a pension scheme/product? If not, is there a better alternative we have not considered?

Q6. When considering which age cohorts to consider, is the example we have provided appropriate? Alternatively, would it be more effective to mirror the DWP's approach?

Combined answers to Qs 5 and 6

Given age-related differences in asset allocation, we strongly agree that for the purposes of a scheme being accountable to its own members or governance body, reporting net-returns on an age cohort basis will better represent the member experience that should be at the heart of a value for money assessment. Rather than the DWP approach of showing age specific results at 25, 45 and 55, we think it is better to report results for different age cohorts, as this will better capture the variations in asset allocation across cohorts. Disclosing results only for specific ages will not account for any differences in asset allocation at other ages for which performance is not shown.

Five-year cohorts may be a typical cohort size, but we suggest leaving the precise size of the age cohorts to the discretion of schemes, in recognition of the diversity in age-related asset allocations that may be pursued. Schemes should report at a size of cohort that fully captures the range of age-related asset allocations.

However, for the purposes of market wide comparisons and benchmarks, age cohorts may be less helpful. The assumption made about what members will do at retirement will drive different approaches to lifestyling and so different asset allocations. This makes an industry wide approach challenging to develop.

Q7. What disclosures, if any, should be made for self-select options?

Where self-select options are individual funds with no age-related component to their asset allocation, a single net performance figure is sufficient. The time period over which this is reported should align with those of the default i.e., minimum five years and longer term where available.

If self-select options are strategies that consist of multiple component funds with age-related variations in asset allocation, then performance disclosures should reflect this and mirror the format set out in our response to the previous questions.

However, we do not advocate this approach in the non-workplace pensions market, where the concept of a 'default' that stands in contrast to 'self-select' options does not exist. Non-workplace pensions offer customers a large menu of investment options which already report past performance through fund fact sheets or KIIDS on underlying funds. Further regulatory disclosures are unnecessary here, would generate additional cost for no benefit and would be entirely impractical given the number of self-select options that are available in non-workplace products.

Q8. Do you think reporting based on age cohorts would be enhanced through the use of risk-adjusted returns as an element of a scheme's VFM assessment or would risk-adjustment then be unnecessary?

Q9. If risk-adjustment is used, what risk-adjustment metric(s) would you suggest? For example, the Sharpe ratio as i) a standalone factor, or ii) in combination with other risk metrics?

Q10. Is there any reason why it would be impractical to report on risk-adjusted performance metrics in addition to providing a metric based on actual performance returns?

Q11. What are your views on presenting returns as an annual geometric average to provide consistency with the DWP's requirement?

<u>Combined answer to Qs 8-11</u>

With respect to presenting returns as an annual geometric mean, we think this is the number that is most likely to be understood by scheme members and is fine for that purpose. However, for their investment decision-making trustees and IGCs should consider risk-adjusted returns when assessing investment performance.

We therefore support the disclosure of returns on a risk-adjusted basis. 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.

However, we do not think prescription on how risk-adjusted returns are calculated is necessary. As the discussion in the DP sets out, there are a number of ways of measuring the risk-adjusted return of a portfolio, with no single correct answer. It would be more appropriate for trustees and IGCs to select a measure of risk-adjusted returns in the context of their own scheme and the investment objective they are seeking to deliver.

We do not think risk-adjusted disclosures are appropriate for customers in the non-workplace market as these measures are complex and unlikely to be understood by a non-professional audience. For such customers the concern is that measures of investment risk serve to confuse rather than inform. They may also distract from the bigger risks facing pension customers that arise from saving insufficient amounts or investing too cautiously to maintain the long-term purchasing power of their money.

Q12. We would welcome views on how you see this [benchmarks] developing. Would it be helpful/possible to establish a benchmark, or would you prefer to compare cohorts against a market average or against a few selected similar schemes? If so, how would that selection be made?

Q13. Do you think a commercial benchmark is likely to emerge if returns data are made publicly available?

<u>Combined answer to Qs 12-13</u>

There is a need to be clear about exactly what benchmarks are measuring and why. Investment managers are used to benchmark comparison for their own delivery at fund or mandate level, but this only tends to work when it is undertaken on a like-for-like basis.

The discussion paper highlights the difficulties in making performance comparisons across pension schemes. Given the diversity in investment objectives and the investment budgets allocated to delivering those objectives, combined with different overall cost bases for scheme delivery, our view is that market-wide comparisons and benchmarks should be considered with significant caution. The member return will differ because schemes have different overall cost bases and follow different investment strategies whose objectives, associated asset allocation and cost are 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.

Rather than seeking to drive market-wide benchmarks, regulators should instead encourage schemes to assess their investment performance against investible benchmarks that are appropriate to the scheme's own strategy. By this we mean moving away from assessing the performance of default strategies solely against member-driven objectives such as CPI+X, towards the assessment of performance against benchmarks that can be invested in and have a tracking error, such as a simple market index-related benchmark (or a composite where the investment strategy is multi-asset).

The idea here is to distinguish between assessing performance against the overall member goal (is the CPI+X target being achieved?) versus assessing the value for money of schemes' investment decisions. The latter is achieved by measuring the investment strategy against a simple, low-cost alternative (what is the impact of the scheme's investment decisions relative to a simple, low-cost investment option?). Trustees and IGCs should have the discretion to select the appropriate investible benchmarks most relevant to their scheme.

<u>**Customer service and oversight**</u>

Q16. Do you agree the effectiveness of governance is a relevant factor that contributes to long-term VFM?

Yes, the effectiveness of governance is critical in contributing to long term value for money. This is particularly the case for investment in DC, where outcomes are not guaranteed.

The design and governance of the default strategy (and other investment options offered to members on a self-select basis) is, alongside contribution levels, a significant contributor to maximising the chances of a good outcome for members. It is therefore vital that the standard of the investment decision-making process by schemes should be as high as possible.

While we are generally wary of direct cross-scheme comparisons, this does feel like an area where a common set of standards may be more appropriate. This is because, quite apart from the investment beliefs set and the decisions taken, there are a number of factors that should be common to the process of setting those beliefs and arriving at a particular set of investment decisions, along the lines of the factors covered in paragraphs 18-20, chapter 4 of the discussion paper.

<u>**Costs and charges**</u>

Q21. Should we use the existing administration charges and transaction costs definitions in developing VFM costs and charges metrics?

Q22. Would splitting out the administration charges be a more useful metric? If not, are there other definitions you think would be more appropriate?

<u>Combined answers to Qs21-22</u>

We strongly believe that more granular disclosure of the costs of pension provision is needed for trustees and 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, we believe the ability of trustees and 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 – is an additional step necessary in the transparency process.

Considering the cost of investment separately from other costs in bundled pension provision would allow for a better assessment of value for money of investment, as well as giving trustees and IGCs the tools to assess whether they believe the investment budget is appropriate within the total cost of the product.

A further piece of information which could be considered is for schemes to set out which fees are paid to the commercial sponsors/distributors of the plan, and which are paid to external service providers. The benefit of this step would be to ensure there is a level playing field applied to the management of fees for in-house services in comparison to the fees levied by external providers.

Q23: Do you agree we should introduce benchmarks for costs and charges?

Q24. What are your views on our suggested options for benchmarking costs and charges? If not these options, what benchmarks should be used?

Combined answers to Qs23-24
No, we do not agree that the regulators should introduce benchmarks for costs and charges in isolation: without any reference to the service delivered, they are meaningless and unhelpful. This applies both within and across schemes.

Benchmarking costs and charges would simply reinforce price as the sole point of competition and lead to employers making scheme selection decisions on that basis alone. This is exactly the behaviour that that the Productive Finance Working Group, in its' recent report[2], is seeking to change, by shifting the conversation from a focus on costs to value.

The problem is particularly acute when comparing transaction costs: when assessing them, 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. This immediately renders any attempt to benchmark them in isolation as being extremely problematic.

[2] A roadmap for increasing productive finance investment, Productive Finance Working Group, 2021.