Investment Management Association

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Dear Roy,

CP14/24 Charges in workplace personal pension schemes

Please find attached the IMA response to the consultation. There are two sets of points in particular that we would like to emphasise. First, we would encourage the FCA and DWP to ensure that the technical implementation of the charge cap is consistent across both contract and trust-based schemes. To that end, we would support greater clarity in the definition of transaction costs, and believe that the DWP's proposal to incorporate a degree of flexibility in the event of a temporary breach of the cap should be considered for all schemes. A related point is the desirability of also ensuring greater consistency in the way that both product charges and transaction costs are disclosed.

Second, at a broader level, we note that the imposition of a charge cap is not in itself an answer to achieving quality provision in workplace pension schemes. The key issue here is better defining value for money and placing an emphasis on good governance processes and structures in delivering value for money. As part of this, the IMA accepts that more needs to be done to improve the transparency of charges and costs in delivering investment services, and is working to facilitate such improvement alongside Government and regulators. We have also made our own proposals with respect to the investment governance of DC default arrangements.

We would be happy to discuss any aspect of our response further with you should that be helpful.

Yours sincerely,

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IMA response *to CP14/24 Charges in workplace personal pension schemes*

General comments

The IMA[1] strongly supports the Government's work to improve the quality of workplace DC pension provision. Although we share the Office of Fair Trading's concerns over a charge cap - namely that a cap could have unintended consequences - we are committed to working with Government and the FCA to ensure implementation of the charge cap is effective.[2]

Foremost in ensuring this is to emphasise that the objective of the cap should be to protect members who make no choice from levels of charges *that are not justified*. This is distinct from an objective whose aim is to maximise the impact of the cap – the latter would not be desirable if it came with the consequence of conflating quality with cost. Trustees and IGCs will be required to assess value for money of schemes, which implies that quality must be considered alongside cost. More work is needed by industry, regulators and Government, to ensure that value for money is better defined. We accept that the industry has a specific responsibility to work towards greater transparency and consistency in charge and costs disclosure as part of that debate. The IMA has already taken a number of steps with respect to investment funds and is currently developing further proposals.[3]

With respect to implementation of the cap, there are a number of practical issues. First, given the joint responsibility of the DWP and FCA in making regulations and rules that cover the workplace pensions market, we would highlight the importance of having a consistent definition of transaction costs across the trust and contract-based landscapes. A definition where the wording is identical in DWP regulations and FCA rules would bring the greatest clarity to trustees, IGCs and investment managers alike.

Second, we note that unlike the equivalent DWP regulations for trust-based schemes, the proposed new FCA rules do not contain any provision for flexibility on the application of the cap, in particular to allow for short periods of time where the scheme may not be cap-compliant for reasons beyond the provider's control. There may be good reasons why the cap may be breached by small amounts and regulatory flexibility is welcome in such instances. A short period during which the cap is breached by a small amount does not automatically result in member detriment. We would therefore encourage the FCA to introduce into its rules equivalent flexibilities to that which the DWP is proposing for trust-based schemes.

Third, it is important that compliance - limiting 'administration charges' to 0.75% - does not become a proxy for good disclosure. There should be clear, consistent and intuitive language to explain pension scheme charges. Associated information about transaction costs incurred in the investment process must also be available and we are closely engaged in the relevant Government and regulatory workstreams.

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[1] The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5 trillion of assets in the UK on behalf of domestic and overseas investors.

[2] Office of Fair Trading, *Defined contribution workplace pension market study,* September 2013, p.26.

[3] See enhanced disclosure guidance (http://www.investmentfunds.org.uk/assets/files/industry-guidance/20120920-enhanceddisclosureoffundchargesandcosts.pdf); and new Statement of Recommended Practice (SORP): http://www.investmentfunds.org.uk/policy-and-publications/sorp-0314/

Finally, on a more general point of policy we question the idea that DC arrangements with guarantees or the option of guarantees would not be subject to the charge cap since it implies that a guarantee at any price might be preferable to the uncertainty perceived in pure DC. This is a questionable conclusion to reach since it takes no account of the cost and value of the guarantee. Good investment options that are aimed at reducing volatility might be precluded from being offered in default arrangements due to the charge cap, but there is no judgement as to the value of guarantees that might be offered in schemes that lie outside the scope of the cap. The Government should be wary of creating such an un-level playing field in the DC market because it risks favouring guaranteed products at the expense of non-guaranteed products.

Furthermore, an approach that favours guarantees could go against the general direction of travel on transparency in charging practices, which is at least partly about improving trust in the pensions industry. Guarantees that are opaquely priced could lead to perceptions about providers hiding charges in certain structures and this would be a backwards step in terms of transparency.

Answers to selected questions

Q2: Do you agree that workplace personal pension scheme providers are best placed to ensure compliance with the charge cap?

We agree that it should be workplace personal pension scheme providers that have the legal obligation to comply with the charge cap. They will select all the different service providers in the pensions delivery chain and will therefore be best placed to monitor and control costs in order to comply with the cap. Individual service providers cannot be responsible since they are only in control of the costs of the service they provide. This means that it has to be the entity running the scheme which is responsible for compliance with the charge cap. However, as we note elsewhere in this response, it is important to have consistent definitions and clarity around the nature of charges and costs so as to assist schemes in any practical implementation and ongoing operational challenges that they face.

Q3: Do you think our proposed methodology for deeming default funds appropriately captures members who have not made active investment choices?

Yes, we think the definition of a default arrangement is appropriate and adequately captures those members who have not made active investment choices. We consider that the '80% of membership' test for funds used as effective defaults prior to automatic enrolment duties commencing is a reasonable proxy for the default in the absence of a strategy that has been explicitly designated as a default. Since the rules cater for members to actively remain in non-cap compliant funds where it is their choice to do so (see our answer to Q7 below) we think that the FCA's proposed methodology for deeming default arrangements is appropriate.

While we have no concerns over the idea that core services must be provided within the cap on default arrangements (COBS 19.6.5R(2)(c)) we do have a concern about COBS 19.6.6G where 'designing and implementing an investment strategy' is designated as a "core service". Our concern is that it is not clear what this means since it is too general. It would not be desirable (nor is it the policy intention) to catch under the cap any investment strategy that members actively select. However, as currently written the guidance seems to imply that the provision of *any* investment strategy is a core service and therefore must be caught by the cap. The wording on investment strategies perhaps needs to be more focused on the *default* strategy.

Q5: Do you agree that our proposed calculation measurement of average funds under management during the course of the year is the most appropriate method? If not, what would be a fairer solution for consumers?

The policy of measuring the member's average fund value over the year on specific reference points is sensible. From an investment perspective, the current prevalence of daily liquidity and pricing in the DC market should facilitate such an approach. However, depending upon the way in which different charging structures and practices operate in the pensions market, there is the potential for some practical difficulties to arise, and we would urge a careful approach to ensure that what appears to be a straightforward charge cap at a headline level does not create unintended implementation complications.

Q6: Are there any other charges you believe should be excluded from the charge cap?

The costs that fall within the cap are the right ones and we agree with all the exclusions. We have previously emphasised that transaction costs are necessary in order to obtain any form of investment return and that including them within the cap may limit the manager's ability to trade, possibly resulting in detriment to the member.[4] We therefore welcome that the rules explicitly exclude transaction costs from the cap.

We have already noted in our comments above the importance of consistency between the DWP and FCA approaches to definitions. With regards to the specific language of the FCA rules, we have a concern with the proposed definition of transaction costs in the Handbook glossary as "*any charge made in respect of costs incurred directly as a result of buying, selling, lending or borrowing investments*". This is a very general description which leaves open to interpretation exactly what costs constitute transaction costs and we think it inevitable that further clarification will be required in order to determine what transaction costs are for the purposes of the rules. Therefore it would be helpful if the glossary explicitly stated precisely what costs the FCA regards as transaction costs.

Table One: Transaction costs to be excluded from the charge cap (DWP consultation)

Excluded from the default fund charge cap on MBD: **transaction costs – the variable costs associated with buying, selling, lending and borrowing the underlying investment instrument**
Brokerage commission and fees
Soft commission services included in brokerage fees, e.g. research costs
Transaction taxes, e.g. stamp duty and non-reclaimable withholding taxes on dividends
Spreads, e.g. bid-offer on bonds, FX (and associated costs such as commission)
Other charges embedded in the transaction price, e.g. payments incurred through financial derivative instruments
Deductions of expenses or fees from profits such that they are not shared equally with members, e.g. in relation to activities such as stocklending, interest income, foreign currency exchange

Source: DWP

[4] http://www.investmentuk.org/assets/files/consultations/2013/20131128-dwpchargesconsultation.pdf

In that regard and in line with our earlier comments, including a version of Table One above taken from Annex B of the recent DWP consultation *'Better workplace pensions: Putting savers' interests first'*[5] in the FCA Handbook glossary would be a positive step. We regard this as a good list of exclusions from the cap.

However, as we have already highlighted to the DWP in our recent response[6] to their consultation, there are some further points to note in relation to this list. Although we think that taxes should be excluded from the cap, they are strictly speaking not transaction costs. More importantly, we think there is a distinct lack of clarity around item 6 in the list –"deductions of expenses or fees from profits such that they are not shared equally with members". This appears to be addressing a circumstance in which profits arise by reason of the holding or exploitation of a client's property and some of those profits are retained by the fund manager, by agreement. These include interest on bank accounts which the Financial Services and Markets Act envisages can be retained under FCA rules and which consequently provides protection from what would otherwise be a breach of fiduciary duty.

We have difficulty understanding how the wording that relates to them not being "shared equally with members" could be correct. It would appear that this is not a matter of equality but about equitable accounting and that it should refer to the retention of any interest or fees arising from cash belonging to members (investors) under the control of the manager and from the lending of stock. The IMA would be happy to work with the DWP and the FCA to provide further clarity on this point.

More generally, we think it important that the term 'administration charge' (or member-borne deduction) is seen as a compliance term and not a term that is included in disclosures to members. To give a concrete example, a scheme that operates a contribution charge or administration charge in combination with an ad valorem charge on funds under management will be required to show that total administration charges do not exceed the charge cap.

For individual members, however, we would like to see disclosure using clear and intuitive language that embraces best existing practice. Since 2012, the IMA's Enhanced fund charges and costs disclosure guidance has recommended that the investment industry focus on the Ongoing Charges Figure (OCF) in preference to the Annual Management Charge (AMC). The OCF covers all the charges associated with running the fund – investment management, regulatory, safekeeping and administrative charges. It therefore has the benefit of being a more complete measure of charges than the AMC which covers only the investment management charge. The OCF is also a more intuitive measure than the Total Expense Ratio (TER), which replaced the TER in the UCITS regime.

We note that the FCA itself has subsequently echoed the importance of focussing on the OCF[7] in investment funds. Subject to appropriate methodology, we think it would be beneficial to adapt the OCF for the pensions environment, since it represents the clearest and most intuitive measure of the charge paid for by the investor or saver.

As a final point, there is one area where we wish to clarify the FCA's policy in relation to the charge cap. Para 2.37 (page 13) of the consultation paper discusses the proposed exemption from

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[5]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364567/better-workplace-pensions-putting-savers-interests-first.pdf

[6]http://www.investmentfunds.org.uk/assets/files/consultations/2014/DWPDCqualityresponse-November14.pdf

[7]http://www.fca.org.uk/static/documents/thematic-reviews/tr1407.pdf

the cap in cases where the member explicitly agrees to non-standard services being provided outside the standard charging structure of the scheme. The text then cites as a possible example of such a service a *"drawdown arrangement to access their benefits from the scheme…"* We find this reference confusing. Our understanding of Government policy on the charge cap and the proposed DWP regulations and FCA rules that implement this policy is that the cap applies only to the accumulation phase of pension saving and not to any retirement income products. However, the above reference gives the impression that the cap could also apply to retirement income products. We would appreciate clarification from the FCA that the charge cap does indeed only apply to default strategies in the accumulation phase.

Q7: Will clarifying the option of moving all their invested funds into a new default arrangement achieve the objective of moving consumers to lower charging options where suitable? If not, what other measures could be taken to achieve this?

The principle that members can actively opt to be in a strategy outside the scope of the cap is vital, otherwise investment choice for members who want it will be unfairly restricted. In that regard, we consider it crucial that FCA rules allow for members to consent to remain in investment arrangements whose cost may cause the charge cap to be breached. We are therefore pleased to see that the FCA's proposed rules cater for this possibility as long as written member consent is obtained.