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Date: 19 June 2018

Dear Donald,

RE: Regulating the pensions and retirement income sector: Our strategic approach

The Investment Association[1] welcomes the opportunity to provide input to the FCA and TPR's joint call for input on their approach to regulating the pensions and retirement income sectors. Our members are a critical, and increasingly visible, component of the pensions value chain and we provide comments on this call for input as a key stakeholder in a well-regulated and successful pensions sector.

Our comments focus mainly on the DC pensions market and cover three main areas, which we discuss in more detail below in our answers to the questions posed in the call for input.

A key threat to good member outcomes is low contributions. We agree that the biggest potential harm in the pensions sector is the possibility of people having inadequate or lower than expected levels of income in retirement. In our view current low rates of pension contributions are likely to be one of the most significant risks to good outcomes.

This issue needs to be addressed as, no matter how competitive and well regulated the pensions market is, this will not in itself be sufficient to deliver good outcomes for members. While we recognise that responsibility for raising contribution rates is beyond the remit of regulators and is a matter for public policy, the issue should be recognised for the

[1] The Investment Association is the trade body that represents UK investment managers, whose 240 members collectively manage over £6.9 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

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risks it poses. It may be possible for regulators to work in concert with Government and the pensions industry to help provide appropriate messaging for individuals in this area.

Investment needs to be at the centre of DC schemes. Along with contributions, investment outcomes are the key determinant of good member outcomes, in both DB and DC schemes. While DB investment strategies are highly sophisticated and typically developed following an analysis of the scheme's liabilities, the starting point for DC investment is different. In a market whose mindset has been heavily influenced by compliance with automatic enrolment duties and the presence of the charge cap, DC investment strategies are often built to a significant cost constraint where investment will compete with other factors such as administration in the context of bundled charges. The result is a market in which investment strategies may not always be optimal from a member perspective.

Both TPR and FCA can take a number of actions here to help the market focus more on the need to put investment at the centre of DC scheme design:

- Educating employers about the importance of investment strategy in scheme selection decisions.

- Emphasising again to trustees and providers the need for strong investment governance, drawing on good examples from across the market.

- In bundled workplace pension schemes, providing oversight bodies with the investment costs separated from the overall product charge to assist value assessment.

- Helping change the debate on DC investment to one that is focused on value rather than cost.

These actions should in time help to raise the profile of investment in DC and ensure that investment strategy design is given more priority across the market.

Helping people obtain good retirement outcomes. The Pension Freedoms provide welcome flexibility to individuals over how they access their retirement income. At the same time, they have clearly created a more complex choice environment. Active decisions are inevitable, but there is clearly a risk of poor decisions without the right support framework.

Professional advice is vital in helping people achieve good outcomes and there is merit in the FCA and TPR working with Government, employers and the pensions industry to emphasise to consumers the importance of taking advice, as well as looking at different ways to facilitate access to advice.

In the non-advised market schemes and providers may be able help individuals reach a decision on the right approach to accessing retirement income by using guided engagement in the form of simplified pathways or decision trees that help identify the best choice for them and the FCA should look to facilitate such outcomes.

We hope this response is helpful and we would be happy discuss it with you further.

Yours sincerely,

Imran Razvi, Public Policy Adviser

RESPONSE TO CONSULTATION QUESTIONS

Q1: FCA and TPR's remits intersect in some areas. Do you see this working effectively, or are there areas where this could be improved?

Given their respective remits, there is a structural coordination challenge for FCA and TPR in regulating the pensions market. Closer coordination between the two regulators is increasingly evident and helping to overcome this. With respect to the DC market specifically, there is further scope for coordinated messaging given that the key challenges in this market do not relate to specifics of different regulated structures (contract vs trust-based) but to cross-cutting themes such as governance, which are covered in the paper and in our response below.

Q2: Do you agree that the areas we have identified are the right ones? If not, which themes would you add or remove from our list? In which areas could the FCA and TPR singly or jointly have the most impact?

We agree that the biggest potential harm in the pensions sector is the possibility of pension savers having inadequate or lower than expected levels of income in retirement. While the FCA and TPR are right to highlight that this could be for a variety of reasons, not all of which they can address, our view is that low rates of pension contributions represent one of the greatest risks for poor outcomes.

There is a clear role for public policy to take the lead here with respect to areas such as providing savers with messaging around the need to save more, or even an extension of the soft-compulsion approach, through increases in the minimum required contributions under automatic enrolment. Tax incentives are also clearly important in helping to shape contribution patterns and we have previously advocated[2] changes here: notably eliminating the Lifetime Allowance or at least making it a contribution-based limit, rather than a cap on the total pension pot, which acts to penalise DC savers who may have benefited from strong investment returns. Alongside such policy responses, techniques such as auto-escalation and employer-matching could work in nudging contribution levels upwards.

While we understand that responsibility for raising contribution rates is beyond the remit of regulators and is a matter of public policy, it may be possible for regulators to work in concert with Government and the pensions industry to help provide appropriate messaging for individuals in this area.

Beyond contribution risk we believe the right areas have been identified. We would particularly encourage the TPR and FCA to focus on three areas in particular: ensuring a high quality of governance at pension schemes and providers; ensuring the debate about value for money of investment starts from a position of performance net of investment fees, rather than being about cost; and supporting consumers to make decisions about how best to access their retirement income. We discuss these matters further in our response to some of the questions below.

Q3: Given our regulatory remits, what more, if anything, should the FCA and TPR do to support people as they start to save in a pension?

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[2] See our response to the Government's 2015 consultation on pensions tax relief, available at https://www.theinvestmentassociation.org/assets/files/consultations/2015/20150930-pensionstaxrelief.pdf

We think the existing roles in regards to regulation are the right ones. TPR should ensure that employers meet their AE obligations and that schemes used for AE meet the requirements for qualifying schemes. FCA should continue to focus on ensuring that contract-based products are appropriately regulated.

Beyond this we believe that in the auto enrolment market, there may be a role for TPR to play in helping employers think more about the role of investment strategies in their scheme selection decisions.

DC outcomes are clearly determined by a combination of contribution levels and net investment return. There is evidence[3] to suggest that in some parts of the auto enrolment market, employer decisions on scheme selection place a lower weight on investment strategy in comparison to other areas such as efficiency of employer processing, quality of member communications and scheme charges. This has led to a situation where providers in some parts of the auto enrolment market compete on a bundled price well below the charge cap e.g. 50bps or lower. In this part of the market the investment budget is often the residual after administration costs have been accounted for[4].

While cost is clearly an important consideration because of the impact of charges on member outcomes, current levels of pricing in parts of the bundled scheme market may not necessarily be in the interest of good member outcomes, being instead a mechanism to assist pension providers in winning or retaining business from employers. The danger of such an approach is that DC investment strategies are designed with regards to meeting a heavy cost constraint rather than being designed with specific member-focused objectives in mind. This could result in DC investment strategies that do not maximise the chance of achieving good member outcomes. This is in contrast to DB, where investment strategy starts from an analysis of the scheme's liabilities, which are the aggregation of member entitlements.

We consider the low prioritisation of investment in DC scheme selection decisions by employers to be a significant driver of competition on product features other than investment. In this context we see a possible role for TPR in helping employers understand the benefits for members of placing a greater focus on DC investment design in scheme selection decisions. Such a change in emphasis should in time lead to investment strategy becoming a greater point of competition in the auto enrolment market.

Q4: Is there more scope for TPR/FCA working, either singly or jointly, in this area? To what extent should the emphasis be on collaboration with a wider group of bodies to improve the advice and services supplied to schemes (e.g. administrators, investment consultants)?

Putting investment at the centre of DC schemes

We strongly agree with the FCA and TPR's statement in paragraph 3.28 of the call for input that for all schemes, investment outcomes are key in ensuring good outcomes for members. Investment should therefore have the same priority in both DB and DC.

Accordingly we think there needs to be a renewed focus on investment governance, particularly in the DC market, where as we have discussed in our answer to question three, investment strategy design does not always feature highly as a priority in scheme design and selection decisions in some parts of the market. An emphasis on the investment process in scheme design, selection and value assessment will help to facilitate better long-term member outcomes. We think there is scope for both TPR and FCA to further

[3] See for example 'Pension Scheme Governance', Pensions Insight, NEST, 2018.

[4] We discussed the dynamics of the bundled auto enrolment market and its implications on investment strategies in our response to the DWP's 2017 Automatic Enrolment Review, available to download here.

emphasise[5] to trustees, pension providers and IGCs the importance of embedding good governance into the design and on-going monitoring of DC investment strategies, particularly the default.

The key elements of such an approach include the need for a clearly identified member-focused objective for any default arrangement that answers the question: "what are you trying to achieve for the members?" For some, this may be related specifically to an ambition to deliver in excess of inflation, preserving purchasing power. For others, it may be more general, relating to maximising return while controlling risk.

Once specified, the member objective should then be delivered with an appropriate investment strategy, whose performance net of fees should be monitored on an on-going basis to ensure that it is delivering against the member objective. The member objective itself should be reviewed over time to ensure that it remains suitable for the scheme membership.

While there are some excellent examples of such processes at specific DC schemes, it is not yet systematic across the market and we believe there is a role for both the FCA and TPR to help embed it into the governance processes at pension schemes and providers. The benefits of this will be DC investment strategies being designed with the needs of members in mind rather than according to a cost constraint. This should increase the likelihood of good outcomes for members.

Regulation of investment advice to pension schemes

The advice received by pension schemes, both DB and DC, from investment consultants generally concerns asset allocation, manager selection and possibly specific investment instruments. The first two elements can be provided in a way that does not fall within the FCA's regulatory perimeter[6].

The FCA's Asset Management Market Study[7] and the resulting CMA investigation into the investment consulting and fiduciary management market[8] have highlighted concerns that pension schemes find it hard to assess the quality of advice as measured by asset allocation.

In light of these points and the fact that asset allocation decisions are a key driver of scheme returns[9] and therefore member outcomes, we repeat our support for the FCA's proposal to recommend that HM Treasury, subject to the outcome of the CMA investigation, should bring the advice provided by investment consultants to institutional investors within the regulatory perimeter of the FCA[10]. Making this advice a regulated activity will allow the FCA to set performance standards or assessment criteria that trustees and employers will be able to use to hold investment consultants to account for the advice they provide. It will also give the FCA the authority to ask the investment consulting industry to develop ways to measure and assess advice itself.

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[5] We note the TPR does have some existing guidance on investment governance as part of its DC Code of Practice.

[6] See 'Final Decision: Market Investigation Reference (MIR) on investment consultancy services and fiduciary management services', FCA, 2017. For a more detailed analysis of the legal framework for institutional investment advice, see Annex Two of the IA's response to the CMA working paper on information on fees and quality.

[7] MS15/2.3 Asset Management Market Study: Final Report, FCA 2017.

[8] Investment Consultancy Services and Fiduciary Management Services Market Investigation: Statement of Issues, CMA, 2017.

[9] There is a significant body of work on the impact of asset allocation on returns. See 'Setting the Record Straight on Asset Allocation', CFA Institute, February 2012 for a good discussion of the literature.

[10] See paragraph 2.36, MS15/2.3 Asset Management Market Study: Final Report.

A similar analysis applies to the advice that is given by Employee Benefit Consultants (EBCs) to trustees and employers in the DC workplace pensions market in relation to the creation of the default investment strategy in these schemes. DC default strategies are typically multi-manager and/or multi-asset solutions, with the EBCs creating their own default strategies by blending external managers' products. The advice provided here would appear to fall into the same category as more traditional institutional investment advice.

Q5: How can pension providers and schemes, employers and other firms in the sector improve the security of the money and data they hold? What role is there for FCA and TPR in further driving up standards?

Asset managers and the products and services they sell to pension schemes and other investors are subject to a sophisticated and robust regulatory regime which ensures a strong degree of protection for the industry's clients. The asset management business model comes with additional protection for clients in the form of segregation of client assets from the manager, with client assets held separately with a custodian bank. Were an asset management firm to fail, this separation will ensure that client assets are unaffected.

The life fund model, heavily used to deliver funds to DC pension schemes in particular, does not rely on this segregation. Instead assets are held on the insurer's balance sheet and clients issued with a policy that provides a claim on those assets. These arrangements are regulated by the PRA. We recommend that the PRA is included in discussions with TPR and FCA with regards to matters of security of pension scheme assets.

Q6: Are there any further opportunities for FCA and TPR to support the delivery of value for money, either singly or together?

Breaking the equivalence between low cost and quality in DC

We have previously set out our view that we do not support a charge cap because of its unintended consequences on DC investment strategies: drawing an equivalence between low cost and quality that leads DC scheme decision makers and members to focus exclusively on price; and a consequent distortion in investment decision-making towards cheaper asset classes and management styles. We set out evidence in our response to the DWP Review of Automatic Enrolment[11] that suggests these unintended consequences have been borne out in practice.

As we have discussed above we believe this may have consequences for members if the strategies they are invested in are being designed to a cost constraint rather than a member-focused objective. We think the FCA and TPR can help the market by shifting the tenor of the conversation on investment and focusing on value rather than cost. This should help give DC asset allocators the confidence to design strategies that start with a focus on member needs rather than the minimisation of cost.

In this regard, the FCA's forthcoming rules[12] on assessment of value in authorised funds are helpful in setting out quality of service and fund performance alongside costs as key metrics in the assessment of value provided by these products. This provides a clear sign that value is about more than cost.

Additional transparency: separating investment costs within bundled workplace pension charges

We support transparency of all investment costs, including transaction costs, and have developed new mechanisms to make this information more accessible for pension

[11] Response to the DWP Review of automatic enrolment – initial questions, The Investment Association, 2017.
[12] COLL 6.6.20-21R, due to come into force on 30 September 2019.

schemes[13]. We will shortly be undertaking further work to implement the findings of the FCA's Institutional Disclosure Working Group (IDWG).

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, governance etc.

For this reason, an additional step may be necessary in the transparency process: the ability of scheme decision makers and governance bodies to be able to access 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.

As with the FCA's new rules on transaction cost disclosure[14], we see such information as being primarily of use to scheme decision-makers and purchasers – pension providers, trustees, employers and advisers. However, pension schemes could take a view as to whether and how such granular information should be made available to scheme members in the context of their communication strategies.

Q7: How can FCA and TPR work, singly or together, to ensure that information and advice helps people make appropriate decisions? When are people most vulnerable to taking poor decisions?

Helping people obtain good retirement outcomes

People are probably at their most vulnerable to taking poor decisions at the point of accessing their pension, whether that is a one-off decision or on a repeated basis through retirement. This vulnerability may be exacerbated with age due to cognitive decline.

At first sight, this would suggest the need for a default approach. However, we doubt the possibility of a true default akin to the accumulation phase being devised for retirement income products: the limits of an inertia-based decision-making process become particularly apparent as savers move towards retirement and confront potentially very different aspirations and individual circumstances. In the retirement phase, there are two sets of critical questions in the world of the new Pension Freedoms.

1. What is the course of action if a pension scheme member or customer expresses no further preference at all?

A true default arrangement in relation to a specific retirement income product is very difficult to envisage, given the inevitability of different individual circumstances. Remaining invested ahead of a definite decision on direction is arguably the only possible action because it does not involve the pension provider making a product choice on behalf of the customer and crystallising their account.

Such an approach will keep the customer's options open and give a scheme or product provider the time to engage with the customer to help them navigate the choice of how to access their DC pension savings.

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[13] The IA has developed the DC Pensions Template (DCPT) to facilitate the flow of information to trustees and IGCs required under the FCA's COBS 19.8. The template is available on the IA website.

[14] COBS 19.8

A DC scheme could have its accumulation phase asset allocation tailored accordingly to provide such flexibility while taking some risk off the table for plan members.

2. How to facilitate a decision over which product type is most appropriate e.g. is it really wise to take cash? Is there a need for longevity protection? Is there a need for certainty of income or can it be more variable?

Professional support is the cornerstone of developing better retirement outcomes. This means ensuring consumers are properly supported through the provision of advice and guidance. For many savers, professional advice will be the best route and there is merit in the FCA and TPR working with Government, employers and the pensions industry to emphasise to consumers the importance of taking advice, as well as looking at different ways to facilitate access to advice.

In the non-advised market – likely to be a high proportion of the auto-enrolled market - there is clearly a significant potential challenge in ensuring that savers can access appropriate investment strategies where they opt to remain invested rather than purchase a life annuity.

Schemes and providers may be able to help individuals reach a decision on the right approach to accessing retirement income by using guided engagement in the form of simplified pathways or decision trees that help identify the best choice for them.

This was the direction of travel in the FCA Retirement Outcomes Review Interim Report, and we support the concept of simplified product pathways, particularly in the non-advised market. The FCA should look to facilitate such outcomes.

Q8: Do you believe that the macro trends that we have identified are those most likely to drive change across the pensions and retirement sector? If not, what are the trends that matter? Which trends should be the highest priority for TPR and FCA? How will those trends (and any other drivers of future risks and opportunities) affect the areas we have identified?

We do not disagree that the factors identified in 3.45 may be influential in determining behaviour, but strictly speaking, not all are trends. Feedback from the macro economy is a factor that is potentially highly significant given one critical trend missing from 3.45: "Greater individual responsibility for pension saving during working life and in retirement", which captures the reality both of the transfer of risk and greater decision-making freedom over retirement income.

This trend towards individual responsibility will possibly make short-term macro economic developments very influential (eg. market volatility, low interest rates). This is correctly reflected in 3.46 ("*greater market volatility and the potential for fluctuations in the value of assets may also dent confidence in pension saving*"). However, market volatility is an inherent feature of capital markets, and low interest rates may or may not be a longer-term trend.

A second trend that we believe is implied, but should be more explicit is that labour market changes may be highly influential in later life behaviour, leading to much less predictable retirement dates and more flexible patterns of work in and around retirement.

A key consequence of the DC market dynamics that we have described above, in which investment strategies are often built to cost constraints rather than starting from a member focus, is a dominance of passive investments and lower degrees of diversification than DB schemes[15]. It is clearly for pension schemes to decide on their investment strategies and we do not advocate for any particular type of investment style or product. However, we

[15] See the IA response to the DWP automatic enrolment review for some evidence on the DC investment market.

strongly believe there is a danger of building investment strategies to a cost constraint rather than a member focus, as it limits the investment tool kit available to those constructing an investment strategy. Accordingly we call for DC investment strategy design to be at the centre of DC pension products, because well-constructed and well-governed strategies will improve the chances of good member outcomes. As we outlined in our answers to questions four and six, the FCA and TPR can help here by taking a number of actions to help make investment considerations as important a part of the DC pensions market as they are in the DB sector.