THE INVESTMENT ASSOCIATION

Written evidence submitted by The Investment Association to the Work & Pensions Select Committee inquiry on Pension costs and transparency

Summary

- The Investment Association (IA) represents the asset management industry operating in the UK. Our members manage the investments of UK defined benefit (DB) and defined contribution (DC) schemes, as well as other retail savers and institutional investors. They are responsible for the management of almost £7.7 trillion of assets in the UK on behalf of domestic and overseas investors.

- A combination of regulatory change, customer demand and industry initiatives are resulting in the UK developing world-leading standards of disclosure of the costs of investing to pension schemes and other customer groups. This information will significantly enhance investors' ability to hold their asset managers accountable for what they deliver, and better to assess 'value for money' (VfM) of investment services.

- The creation of IGCs and the enhanced governance requirements placed on trust-based schemes, including VfM assessments, are important customer protections in the context of automatic enrolment. They have brought strong scrutiny to the overall cost base of default arrangements, which is primarily composed of administration (record keeping) and investment. While cost is clearly important, value is ultimately about what has actually been delivered for a given cost. The next stage of VfM will require a greater focus by IGCs and trustees on the outcomes schemes are trying to achieve for savers and more specifically, the investment strategies necessary to achieve these. This in turn will need a greater focus on investment governance processes and the performance of default strategies.

- There are further actions grounded in behavioural finance which schemes and policymakers can take to improve consumer outcomes. Most notably, inertia-based policies still have more to achieve, for example through automatic escalation of contributions[1]. Policymakers and schemes will need to find the right balance, but engagement (and appropriate support) is going to be increasingly necessary, particularly in the run up to and at the point of retirement. Both the pensions and investment industries are taking initiatives to improve clarity of communication and develop tools to help customers.

- Transparency of costs matters in different ways to different groups. For savers, it is clearly important to feel confident in providers, and cost accountability is an important dimension here. However, in areas such as investment transaction costs, the users of information will be those who demand and design better investment strategies – trustees, pension providers, IGCs, consultants, employers – to determine how efficient asset managers have been in delivering a target objective.

[1] Auto-escalation is a process for increasing contribution rates where employees agree in advance to take a percentage of any future pay increases in the form of an enhanced pension contribution. Also known in the US as "Save more tomorrow" schemes, auto-escalation can be an effective way of increasing savings without compromising current household budgets or living standards.

Transparency and the investment process

1. Investment managers are providers of investment products and services for pension schemes, but are for the most part not the providers of pensions and retirement products. These will generally be insurance companies and trust-based schemes. This has significant implications for the disclosure of costs and charges that we discuss in more detail in our answer to Q1 below.

2. With respect specifically to investment products and services, regulators and customers have historically focused on asset management fees (i.e. the fee specifically paid to managers for managing investments). This has changed significantly in recent years, with an increasing focus on transaction costs: ie. the on-going market cost of transacting to execute the scheme's investment strategy.[2] These comprise both explicit costs (brokerage and taxes) and implicit costs (derived from market prices and typically seen in the difference between buy and sell prices). The former are straightforward to quantify, the latter less so as they are not objectively measurable.

3. For UK pension provision, a step change in regulation is taking effect during 2018:

   - In the institutional pension scheme market, MiFID II requires pension schemes (and other clients) to be given pre-sale and ongoing disclosure of transaction costs and charges on an aggregated basis with a detailed breakdown on request.

   - FCA DC workplace pensions disclosure rules (COBS 19.8) require ongoing reporting of a DC scheme's costs and charges on a disaggregated basis. The reports must be made to the trustees and IGCs responsible for assessing the value for money received by members of these schemes. The IA and ABI have developed a machine-readable framework to ensure effective and comprehensive delivery of investment cost information.[3]

   - The Insurance Distribution Directive (IDD) reflects the changed expectation regarding charge and cost disclosure with insured funds, which are frequently used by pension schemes, being subject to cost and charge disclosure requirements that mirror those of MiFID II.

4. This regulatory change is being complemented by other work, fully supported by the investment management industry, notably the Institutional Disclosure Working Group (IDWG) established by the FCA to develop a common template for cost disclosure to trustees. The final output, to be implemented in the coming months, builds on pre-existing work by local government pension schemes together with the IA and asset management firms.

5. As a result of this cumulative process, we are confident that full transparency is being achieved and that pension fund trustees and IGCs will have the information they need to help inform their decision-making in relation to investment. One area remains currently challenging, and this relates to untested regulatory methodologies for implicit transaction costs. The industry – and its customers – are particularly

[2] A more detailed discussion of these issues is available in two IA papers: '*Meaningful disclosure of costs and charges*' (2015) and '*Enhanced disclosure of charges and transaction costs: technical consultation*' (2017)
[3] The DC Workplace Pensions Template (DCPT). Available at https://www.theinvestmentassociation.org/investment-industry-information/data-exchange-frameworks/

uncomfortable with data which shows negative or zero transaction costs, a direct consequence of a methodology imposed by regulators. The IA and its members firms are working closely with regulators in the UK and Europe to achieve a solution.

Q1: Do higher cost providers deliver higher performance or simply eat into customers' savings?

6. All pension provision has a core set of costs and charges: the investment process which generates returns, as well as administration (also known as record-keeping), communication and governance (including professional advice, as appropriate). Depending on the nature of the scheme, DB or DC, contract-based or trust-based, single employer or multi-employer, the configuration and hence the cost base will vary.

7. Performance, defined in terms of the returns delivered to savers, can only be generated through investment return. In a bundled pension scheme, where all fees are contained within the product charges borne by members, that investment return will be reduced proportionately to those fees. For example, the investments of a given scheme may return 10% before fees. If the total charges (investment, record-keeping, communication) are 1%, the impact will be to reduce the return to 9%.

8. The question as to whether higher cost providers deliver higher performance can therefore only be answered with respect to the contribution and level of all of these different components. A higher cost provider could deliver an investment return of 10.5% before fees, but charge 1.5%. The investment performance has been good, but has been eroded by fees. The question from a customer perspective would be whether those fees have translated into a better service – for example, a user friendly website or responsive call centre.

9. In contrast, the link between investment returns and the level of transaction costs incurred is not linear in the way that it is between returns and the level of fees paid to providers. Incurring higher transaction costs is not necessarily a negative outcome if the investment strategy which generates the transaction costs has led to enhanced performance. Conversely, an investment strategy which does not meet the scheme's objectives, even though it exhibits lower transaction costs, is unlikely to be judged as successful[4]. This overall performance and the ability to effectively meet the scheme's investment objectives and outcomes in the most cost-effective way should form a key part of the assessment of whether VfM has been delivered.

10. From a pure investment perspective, the FCA Asset Management Market Study reiterated findings about performance that have been made elsewhere over many years, namely "there is no clear link between price and performance" at the level of individual fund fees. However, FCA data in the Market Study also showed that across the wider universe of funds, actively managed equity funds delivered higher returns over the period studied (2003-2015) than their benchmarks.[5] This suggests that the

[4] A visual representation of the relationship between investment returns, charges and transaction costs is available in the *IA response to the FCA Asset Management Market Study Interim Report*. See in particular Exhibit 13, p52 and paragraph 179.

[5] This finding is discussed at length in the IA's response (2017) to the FCA Asset Management Market Study Interim Report, available to download at https://www.theinvestmentassociation.org/assets/files/consultations/2017/IA_response_to_FCA_Market_Study_Interim_Report.pdf See in particular Part 2, section 4 and Annex One, section 5.

answer as to how best to invest lies not in a focus purely on cost, but on the objectives and investment process in the context of the costs.

Q2: Is the Government doing enough to ensure that workplace pension savers get value for money?

11. The creation of IGCs and the enhanced governance requirements placed on trust-based schemes, including value for money assessments, are important consumer protections brought in by the Government to try and ensure that workplace pension savers receive value for money.

12. Thus far, much of the debate has been around charges and costs, with the introduction of the charge cap contributing to competitive dynamics in the market being largely focused on price,[6] with providers and trustees focused on minimising costs. This has resulted in a market whereby charges are low, with bundled schemes priced significantly below the cap. The government has strengthened this dynamic by signalling to trustees the need to focus primarily on charges and costs – a recent example of this being the requirement on trustees to publish default strategy charges and transaction costs, with no corresponding requirement to publish default strategy performance.[7] Surprisingly in this context, performance publication is left to the discretion of trustees.

13. All else being equal, low overall charges are to the benefit of investors but need to be judged in the context of what they deliver. Without considering the quality of service and investment performance, it is impossible to conclude anything about value for money.

14. Investment is the beating heart of pension schemes. The focus of DC governance bodies needs to shift towards a wider focus on value, particularly in relation to default investment strategy design and performance. This is mainly for trustees, IGCs and pension providers to do, but Government and regulators can help by signalling that cost should be just one element of a VfM assessment. This is as true for areas such as administration and communication as it is in relation to investment strategy design.

15. Effective investment governance is key to helping members achieve good outcomes[8]. This means setting member-focused objectives that clearly set out what schemes are trying to achieve in the default arrangement. 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 an objective is in place, an appropriate investment strategy can be designed to deliver that objective.

16. This process already takes place in many DC schemes, but is not yet systematic across the market. The danger remains that DC investment strategy is disproportionately characterised by an approach that starts with a heavy set of

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[6] See the IA response to the DWP's 2017 review of Automatic Enrolment for evidence on pricing trends in the workplace DC market. Available to download at https://www.theinvestmentassociation.org/assets/files/consultations/2017/20170317-iaresponetodwpaereview.pdf

[7] The Occupational Pension Schemes (Administration and Disclosure) (Amendment) Regulations 2018

[8] The IA discussed investment governance and default strategy design considerations in a position paper published in June 2018: *'Putting investment at the heart of DC pensions'*. Available to download from https://www.theinvestmentassociation.org/assets//files/Pensions_report_online_version_FINAL.pdf

constraints around cost without a deeper appreciation of the outcomes which are being sought. We do not think such a narrow focus will deliver VfM.

17. Assessment of the value of investment delivery highlights an additional area where cost transparency is needed in pensions. In bundled DC schemes (ie. where there is a single charge for all services), scheme decision makers and governance bodies should be able to access the cost (and performance) of the investment component of a pension product separately from the total cost. This will help better inform DC governance bodies as to whether the investment budget is at the right level.

18. Alongside this, there needs to be greater accountability for default strategy performance, which, along with contributions, is ultimately what drives member outcomes. Default strategies are largely designed by trustees in conjunction with their advisers, and by pension providers in the contract-based market. Asset managers may also be responsible for designing and managing the entirety of a scheme's default strategy, although this is less common in the DC market, where trustees and pension providers generally blend the funds of multiple managers to create a default strategy.

19. In these arrangements asset managers are accountable for the performance of their component funds, but it is trustees and pension providers that are accountable for the performance of the default strategy as a whole.

20. In order to help drive value for money for members, the government and FCA should require trustees and IGCs to publish the performance of the default strategies[9] they provide/oversee[10] in the annual chair's statement alongside charges and transaction cost information.

Q3: What is the relative importance of empowering consumers or regulating providers?

Q4: How can savers be encouraged to engage with their savings?

21. We answer Q3 and Q4 together. Pension saving and investment is not straightforward for ordinary savers, and significant support is needed, whether that is through workplace scheme governance mechanisms, financial advisers or guidance from providers and/or third parties. With respect to decision-making in DC schemes, inertia-based mechanisms clearly have an important role to play (automatic enrolment, investment and potentially escalation of contributions). [11] Here, scheme members should be reassured that trustees and IGCs are looking after their interests in relation to VfM.

22. Nonetheless it is vital that savers are encouraged to engage with their pensions. In the accumulation phase this is particularly about appropriate contribution rates. The level of contributions is critical, with investment processes unable to deliver in

[9] Performance should be shown for different age cohorts of members – reflecting age-related differences in asset allocation that are typical in DC default strategies.

[10] IGCs are not responsible for designing default strategies but they are responsible for assessing the value for money of those strategies. Requiring them to publish performance will help them to hold pension providers to account.

[11] See Shlomo Benartzi and Roger Lewin, *Save More Tomorrow: Practical Behavioral Finance Solutions to Improve 401(k) Plans*, 2012. See also See James Choi, David Laibson and Brigitte Madrian, *Plan Design and 401(k) Savings Outcomes,* 2004.

isolation. Lower contributions put greater pressure on investment returns and higher returns can only be generated by taking higher levels of risk. This may not be something that DC investors are comfortable with, particularly as they age and their ability to absorb losses and make new contributions reduces.

23. One of the central challenges of increasing contribution rates is messaging to individuals about how much to save in the context of uncertain returns. A combination of approaches may be needed. Behavioural economics provides tools beyond inertia-based approaches and offers ways to encourage engagement in a more innovative fashion. For example, some research suggests the use of heuristics / rules of thumb, drawing on perceived success in other areas, such as the 'five a day' approach to eating fruit and vegetables[12].

24. Better communication is also part of the solution. Work has already started with initiatives such as the ABI's work on clarity of language in pension product communication[13]. The IA supports proposals to replace terms such as 'default' and 'decumulation' with more accessible language.

25. The IA is also conducting its own detailed research, both into how to communicate more clearly in fund products and into public attitudes to the investment process, with the aim of facilitating a better communication process between industry and different kinds of saver (and non-saver). The IA will report on the progress of this work later in 2018.

Q5: How important is investment transparency to savers?

26. Opinions polls and customer research over the past decade have consistently found that the key barrier to additional saving centres on concerns about having enough money to set aside, particularly given that a pension is a 'locked box'.[14] Charges and costs do not feature as prominently. Importantly though, that there is also evidence of a generalised lack of trust in, and understanding of, the investment management and wider financial services sectors[15]. In this context, cost transparency has become much more important and we fully accept that it is a foundation of trust, particularly in the post-2008 environment.

27. With respect to transparency in more complex areas of the investment process such as transaction costs, we fully support the need for comprehensive disclosure. However, we believe that the information is more likely to be actively used by pension schemes, trustees and IGCs to be able to assess VfM.

Q6: If customers are unhappy with their providers' costs and investment performance/strategy, are there barriers to them going elsewhere?

28. The architecture of the workplace DC pensions market means that the employer makes the choice of scheme it uses to fulfil its automatic enrolment duties. Employees do not have a legal right to direct employer contributions to a scheme of

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[12] See, for example, Financial Advice Working Group, *Rules of Thumb and Nudges: Improving the financial wellbeing of UK consumers*, 2017. See also Pensions Policy Institute, *Consumer engagement: barriers and biases*, 2017.

[13] '*Making Retirement Choices Clear: A guide to simplifying language on investment options'*, ABI, 2016.

[14] See, for example, *'Savings in the Balance: Managing Risk in a Post-Crisis World'*, Social Market Foundation, 2014.

[15] *'Rebuilding Trust in Long-Term Savings'*, Just, 2018.

their choice. Employees unhappy with the scheme generally may opt out, but will lose the employer contribution.

29. The options available to consumers not satisfied with the default strategy are therefore limited to the self-select investment options available through their scheme. This tends to still leave wide choice in the contract-based DC market. For trust-based DC schemes, the choice may be narrower if trustees make only a limited number of self-select options available, which they may do in order to avoid confusing their members with too much choice. NEST, for example, provides five additional fund choices for members that choose not to remain invested in its default strategy.

Q7: Are Independent Governance Committees effective in driving value for money?

30. IGCs are now in their fourth year and have had to evolve without a precise starting point in the assessment of VfM. Thus far the only formal evaluation of IGCs was a high level set of findings[16] published by the FCA and DWP at the end of 2016. The review *"found IGCs to be generally effective, and acting in accordance with their Terms of Reference, by influencing, supporting and advancing the reduction in costs and charges that has been achieved so far"*[17]. No mention was made of any work done by the IGCs around investment governance and changes to the investment strategies offered by pension providers as a result of IGC recommendations.

31. In light of our earlier comments it is not surprising to see that the metric on which IGCs are being judged is cost. While cost is important we reiterate that low cost is not the same thing as value for money and that a broader consideration of value is needed. In relation to investment this should cover the definition of member-focused objectives, investment strategy design and performance as discussed in our response to question 2.

Concluding remarks

32. The IA and its members are fully supportive of a more transparent delivery process for investment services across the market, and are working to deliver this. A combination of regulatory, customer and industry initiatives is providing pension schemes with the information they need on the costs of the investment process. The next stage of the VfM process for DC schemes needs investment costs to be more systematically considered in the context of clear member-focused objectives and delivery in relation to those objectives. There is more scope for this approach to be taken in parts of the DC pensions market where it is not yet systematic.

The Investment Association, 3 September 2018.

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[16] *'Remedying poor value legacy workplace pension schemes: findings from the joint review of industry progress against the Independent Project Board recommendations'*, DWP and FCA, 2016.
[17] See Paragraph 5.1 of the DWP/FCA report.