THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

Strategy and Competition Division
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

T +44 20 7831 0898
E enquiries@theia.org
W theinvestmentassociation.org
Twitter @InvAssoc

Date: 8 October 2019

Dear Sir/Madam,

RE: FS19/5 – Effective competition in non-workplace pensions

The Investment Association[1] welcomes the opportunity to respond to the FCA's feedback statement on effective competition in the non-workplace pensions market. Our members generally do not provide pension products directly, whether workplace or non-workplace. However, they are a critical component in the pensions value chain and investment management is an increasingly visible part of the new pensions landscape.

We respond to this feedback statement on that basis, offering a number of comments about the issues raised by the FCA.

In particular, we highlight three specific areas:

1. **Unengaged consumers and the role of default investment strategies**. For customers who do not or cannot engage with their investments, we are strongly supportive of default investment strategies because they remove the need for investment decision-making from such customers. A well designed, governed and executed default strategy can significantly improve outcomes for members who lack the understanding, time or inclination to make their own investment decisions, regardless of whether they are in a workplace or non-workplace scheme.

---

[1] The Investment Association is the trade body that represents UK investment managers, whose 250 members collectively manage over £7.7 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.

The UK is the second largest investment management centre in the world and manages 37% of European assets.

More information can be viewed on our website.

The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

However, for advised customers we think a default approach is not appropriate. For such customers the advice process should result in a more bespoke investment solution and the nature of a default strategy – designed for the 'average' investor – means it is by definition highly unlikely to be more suitable for an individual compared to an investment solution designed specifically to meet their needs.

2. **Promoting competition through enhanced disclosure and comparability of charges**. Charges affect the net outcome from an investment product and their level should clearly be part of the decision-making process of customers. The IA strongly supports full transparency of all costs and charges and the presentation of cash numbers alongside a Reduction-in-Yield approach to communicate the impact of charges can aid customers in better understanding costs and charges if this is implemented appropriately.

While publication of market-wide data on charges can aid customers, on its own it is of limited value and we strongly believe that such information must be accompanied by risk-adjusted performance of the product over an appropriate time frame as well as a list of services provided, along with features or metrics that provide an indication of service quality. Without this information, a list of product charges means that purchasing decisions can only be made on charges alone, with the implication that quality is equated solely to low cost. This reduces the incentive of firms to innovate and compete on quality, resulting in products that might be low cost but not necessarily optimal in terms of the outcomes and experience they deliver for customers.

3. **Measures to address charges**. We note that regulators such as the OFT and TPR have previously pointed out that charge caps are an imperfect mechanism that can create unintended consequences. Evidence from the existing workplace pensions charge cap suggests that it is driving a focus on low cost as a proxy for value in some parts of the market, particularly around investment. A cap may create both barriers to entry and sustainability, resulting in limited product innovation and making it difficult for a robust and diverse market in non-workplace pensions to develop.

In our view, strong governance, clear cost and charge disclosure and a clear articulation of value for money delivered is a better route to achieving high-quality, cost-effective products for customers.

In that regard we strongly support the work that the FCA and TPR are doing around considering a value for money framework in DC pensions as this will help both governance bodies and customers assess value for money in terms of quality and cost, rather than an approach which focuses on cost as the main or sole factor in determining value for money. Given that investment outcomes are key in ensuring good outcomes for members, the design, execution and medium-to-long term outcome of the investment process should be a core part of any value for money framework. Such an emphasis will help to facilitate better long-term member outcomes.

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

Yours sincerely,

Imran Razvi

Senior Policy Adviser, Pensions & Institutional Market

RESPONSE TO QUESTIONS ON POTENTIAL REMEDIES

MEASURES TO PROTECT CONSUMERS WHO DO NOT OR CANNOT ENGAGE WITH THEIR INVESTMENT DECISION

Q1: Do you have any views on introducing investment pathways? How many pathways would benefit consumers: one or multiple? If introduced, what criteria should we consider in defining investment pathways for non-workplace pensions? Can you suggest a proportionate alternative?

The role of default investment strategies in non-workplace pensions

1. In the workplace pensions market we have been very supportive of default investment strategies because they remove the need for investment decision-making from pension scheme members who struggle with such decisions. A well designed, governed and executed default strategy can significantly improve outcomes for members who lack the understanding, time or inclination to make their own investment decisions.

2. In principle such an approach is equally relevant for the non-advised part of the non-workplace pensions market, where customers would otherwise be making investment decisions without any support. There is nothing in the FCA's evidence to suggest this group is any better at making investment decisions than members of workplace pension schemes. Therefore we would support a requirement for providers of non-workplace pensions to provide a default investment strategy for their non-advised customers.

3. However, for the advised market we are not convinced of the utility of default investment solutions. Individuals investing in a default solution are by definition going into a 'one-size fits all' arrangement and this works well if the customer is not engaged or not using an adviser. However, the point of investment advice is that customers will have with a more tailored solution and while there is nothing to prevent an adviser from recommending the default solution in a non-workplace pension, it is not clear why there should be a requirement to set out why a recommended investment strategy is at least as suitable for a client than the default. Indeed the 'average' nature of the default means it is unlikely to be more suitable for an individual compared to an investment solution designed specifically to meet their needs.

4. In terms of the number of investment solutions that could be offered as a default, it would be possible for the provider to design multiple solutions, most likely in line with a particular investment objective or risk profile. However, the important point is that the customer is only offered a single default.

The design and governance of default strategies

5. We see strong investment governance as being a key element of customer protection in default strategies and the FCA's rules should ensure that providers carry this out. Good investment governance would involve ensuring that default strategies have a clear member-focused objective (e.g. aiming to deliver returns of CPI+x% over 'y' period) and then an appropriate investment strategy that seeks to deliver this. There should be on-going monitoring of the strategy to ensure that it remains on track to deliver, with any remedial action taken where appropriate. In addition those responsible for governance should ensure that the objective and investment strategy used to deliver it should remain appropriate over time.

6. In that regard the rules in COBS 19.5.5 (R)(2)(a)-(b) set out some appropriate investment governance requirements for IGCs in relation to workplace pension default strategies. These requirements would work well for the design and on-going governance of non-workplace pension default strategies.

7. We note that the FCA highlight the role of de-risking in default investment strategies as a further reason for their possible use in non-workplace pensions. De-risking is a common concept in pensions investing as individuals age and schemes mature and were the FCA to signal its expectations that default strategies should include an element of de-risking, this would be very much working with the grain of current market practice, where approaches such as lifestyling and Target Date Funds are commonly used. However, we would caution against too much prescription here as the precise form of de-risking is typically dependent on how the DC pot is intended to be accessed in retirement: asset allocation glidepaths look different depending on whether the intention is to take the pot as cash, purchase an annuity or go into drawdown. A regulatory expectation that a default investment strategy should include an element of de-risking should be sufficient.

Q2: Do you have any views on applying an 'active decision' requirement to non-advised investments in cash, and additional warnings to all consumers about the impact of such a decision? Can you suggest a proportionate alternative?

8. We have previously supported the FCA's rules on making cash investment an active choice in drawdown and believe the same rationale for its application applies in non-workplace pensions. Holding cash as a long term investment will pose a risk to the real value of the customer's pension pot and investing their money with an appropriate asset allocation will help them earn a better real return.

9. We are also supportive of any proposals requiring consumers to be warned about the impact of investing in cash. In our view while investment risk is a known quantity, customers can focus too much on trying to mitigate it at the expense of exposing themselves to other risks, such as inflation. Cash-investment warnings should help redress the balance somewhat.

PROMOTING COMPETITION BY MAKING COSTS CLEARER AND COMPARISON EASIER

Q3: Do you have any views on the ways we have suggested charges could be made clearer, less complex and more easily comparable? Can you suggest a proportionate alternative?

10. Charges affect the net outcome from an investment product and their level should clearly be part of the decision-making process of customers. The IA strongly supports full transparency of all costs and charges incurred in the investment process as part of a comprehensive wider disclosure process. The work done by the asset management industry in complying with the cost and charge disclosure requirements of MiFID II, PRIIPs and COBS 19.8 as well as ongoing work to deliver the CTI templates for institutional clients means that the charges and costs of the underlying investment process are available for product providers and distributors to use in their consumer-facing disclosures.

11. We are supportive of cash disclosure of costs and charges in non-workplace pension products, though we note that some product providers may face significant operational challenges in implementing them and would therefore suggest the FCA is pragmatic in its approach here.

12. One area where we would encourage the FCA to depart from current practice under MiFID II is with regards to the presentation of charges and transaction costs. In

particular, aggregation of charges with transaction costs can provide a misleading impression about the impact of transaction costs, by implying that the gross return is reduced by the sum of the charge plus transaction costs. This is obviously not the case, as transaction costs are already included in the gross return achieved. We would therefore suggest distinguishing between the service charge (shown as deducting from the return achieved) and transaction costs (incurred in generating the gross return). This is to avoid giving the customer the incorrect impression that transaction costs are an additional charge that further reduces the return achieved.

13. In terms of communicating impact, Reduction-in-Yield approaches would work well in relation to illustrating the impact of charges and could be used alongside charges information. This would have the benefit of showing the customer both the charge paid (necessary for knowing the cost of the service delivered and comparing with other providers) as well as its impact (which addresses the FCA's concern about customers not understanding the impact of charges).

14. Finally, in relation to the simplification of charge structures, while we can see the benefits in terms of facilitating comparability between products if there are fewer and simpler charge structures, this is an area that will require careful analysis by FCA as different charging structures might be better suited to different groups of investors depending on their characteristics and behaviour.

Q4: Do you have any views on publishing charges information? Can you suggest a proportionate alternative?

15. While we do not have any concerns about the publication of charges information per se, we strongly believe that it must be accompanied by: disclosure of the services received e.g. financial planning advice, investment advice, administration; the risk-adjusted performance of the product over appropriate timeframes; and features/metrics that provide an indication of service quality. Without this information, a list of product charges means that purchasing decisions can only be made on charges alone, with the implication that quality is equated solely to low cost. This would reduce the incentive of firms to innovate and compete on quality, resulting in products that might be low cost but not necessarily optimal in terms of the outcomes and experience they deliver for customers.

MEASURES TO ADDRESS CHARGES

Q5: Do you have any views on what remedies or further analysis would be appropriate in relation to the level of charges identified in this market?

The use of charge caps

16. We think the FCA is right to avoid recommending a charge cap for non-workplace pensions. Regulators such as the OFT and TPR have pointed out that caps are an imperfect mechanism that can create unintended consequences. Evidence from the existing workplace pensions charge cap suggests that it is driving a focus on low cost as a proxy for value in some parts of the market, particularly around investment[2]. A cap must cover all aspects of the product, including administration and communication, with all charges borne by the saver. This may create both barriers to entry and sustainability. In consequence, it also limits product innovation. It may be difficult for a robust and diverse market in non-workplace pensions to develop in the presence of a cap.

---

[2] See 'Putting investment at the heart of DC pensions', IA, 2018.

17. We would also highlight that while the charge cap was justified by Government through the existence of automatic enrolment, the same rationale does not carry through to a market in which individuals make an active choice over which product to purchase.

18. In our view, strong governance, clear cost and charge disclosure and a clear articulation of value for money delivered is a better route to achieving high-quality, cost-effective products for customers.

Governance

19. We believe that all customers should benefit from strong oversight mechanisms, and a range of existing obligations on firms will help fulfil this function, some of this explicitly in relation to charges. In particular, alongside existing product governance rules[3], the new value assessment requirements for authorised investment funds[4], many of which will be used in non-workplace pension products via unit-linked fund wrappers, will provide robust protection for customers in relation to value at the fund building-block level.

20. In addition, we note the results of the FCA's recently published work on governance in unit-linked funds[5] and the possible application of new governance remedies for unit-linked funds as a result. Given the predominance of unit-linked funds in the DC pensions market, this will have implications for the non-workplace pensions market because any remedies applied at the unit-linked fund level will provide additional protection to non-workplace pension customers.

21. In light of the new requirements at authorised fund level (which include measures to strengthen independent governance) and possible governance remedies for unit-linked funds, it is not clear that an additional layer of independent governance would provide further benefit to the customer. We agree with the FCA's approach of considering independent governance in light of its work on unit-linked fund governance and IGC effectiveness.

Q6: Do you have any views on what such a framework should consist of?

22. We are strongly supportive of the work that the FCA and TPR are doing around considering a value for money framework in DC pensions as this will have the potential to help both governance bodies and customers assess value for money in terms of quality and cost, rather than an approach which focuses on cost as the main or sole factor in determining value for money.

23. Investment outcomes are key in ensuring good outcomes for members. Accordingly we think there needs to be a renewed focus on investment governance in the DC market, both workplace and non-workplace. An emphasis in a value assessment framework on the design, execution and medium-to-long term performance of the investment process will help to facilitate better long-term member outcomes.

---

[3] Notably PROD 4.2.25 which deals with charging structures for insurance products.

[4] COLL 6.6.20-6.6.24

[5] Unit-linked funds' governance review (follow up to PS18/8): findings and next steps, FCA, 2019.