Department for Work & Pensions

Review of the Default Fund Charge Cap and Standardised Cost Disclosure: Call for Evidence

Response from
The Pensions Management Institute

Pensions Management Institute
Moving pensions forward

Response from the Pensions Management Institute to DWP's consultation 'Review of the Default Fund Charge Cap and Standardised Cost Disclosure'

Introduction

PMI is the professional body which supports and develops those who work in the pensions industry. PMI offers a range of qualifications designed to meet the requirements of those who manage workplace pension schemes or who provide professional services to them. Our members (currently some 6,000) include pensions managers, lawyers, actuaries, consultants, administrators and others. Their experience is therefore wide ranging and has contributed to the thinking expressed in this response. Due to the wide range of professional disciplines represented, our members represent a cross-section of the pensions industry as a whole.

PMI is focused on supporting its members to enable them to perform their jobs to the highest professional standards, and thereby benefit members of retirement benefit arrangements for which they are responsible.

Review of the Default Fund Charge Cap and Standardised Cost Disclosure

What is your name?

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What is your organisation?

Pensions Management Institute

Are you happy for your response to be published?

Yes

Would you like to be contacted when the consultation response is published?

Yes

How did you hear bout this consultation?

DWP email

Part 1 - Including transaction costs within the charge cap

1. *What are the advantages or disadvantages of extending the cover of the charge cap to include some or all transaction costs?*

We sympathise with the concerns that transaction costs could be artificially inflated and cause extra artificial costs for scheme members. However, like yourselves we have not seen any evidence of this and agree with your assessment that transaction costs are usually relatively low.

Therefore, we do not see any significant advantage of extending the charge cap to include transaction costs.

You have already set out the disadvantages of doing so, namely that capping transaction costs could limit fund managers acting in the best interests of members – indeed it is easy to see that constraining fund managers' ability to act could have been catastrophic for members in the Covid-19 pandemic which is precisely the scenario when fund managers should be able to add value for members. We also agree that calculating transaction costs is not straightforward and that there is no perfect method for doing so but that the slippage cost method is the best approximation for doing so.

2. *What would be the impact on scheme member returns/industry if some or all transaction costs were covered by the cap?*

If there was strong evidence of members suffering due to excessive transaction costs then the impact of a transaction cost cap would be positive for members.

However, in the absence of such evidence we fear that a cap on transaction costs would be detrimental to members for the reasons outlined in our answer to Q.1.

For the industry, the impact of a transaction cost cap would be to focus attention on those costs. But we are not convinced that the opportunity cost of focussing on a relatively small cost to members would be merited when there are other issues for the industry to deal with.

3. *Should there be a combined transaction cost and charge cap, or should these be separate?*

If a cap is to be placed on transaction costs then this should be separate to the charge cap. The charge cap is now established and any changes to what it covers are likely to lead to confusion during the transition. A separate transaction cap would be easier to implement and also provide greater transparency than a combined cap.

4. *Who should be responsible for complying with a transaction cost cap?*

Ideally asset managers should be responsible for ensuring that their own transaction costs are below any cap and for confirming annually to their trustee clients that this is the case. However, this will not be feasible for blended or white label funds so we reluctantly have to say that trustees should be responsible. But we point out that this would be yet another compliance cost placed on trustees and, for the reasons outlined above, unnecessarily in most cases.

On a connected note, we note that one of the biggest challenges for trustees has been getting timely and accurate information from asset managers about transaction costs, despite FCA rules taking effect from 3 January 2018 requiring them to do so (as you note in footnote 27 in Chapter 5). Although the situation is getting better, we would welcome any action that can be taken to make asset managers more proactive and helpful in providing this information.

Part 2 - The level of the charge cap

5. *If we lowered the cap, what would be the impact on (a) scheme member outcomes (b) industry?*

Firstly, we would like to caution against simplistic calculations regarding member outcomes that we have seen from certain industry participants. It is clear that if you fix return and volatility assumptions and the only variable becomes the cost, then lower charges will lead to better outcomes (higher pot). However, the reality is never that simple. Low charges buy a simple index tracker that is not trying to achieve any goals apart from tracking the ups and downs of an index. This may be appropriate at certain points of a lifestyle, for example for very young savers with long investment horizons, but inevitably as people approach retirement more diversified, dynamically managed strategies become a lot more important. As a rule of thumb, for those below the age of 40 their pot growth is largely driven by their contributions, and after that point pots are so large relative to contributions that it's market movements that drive growth (or otherwise). Having said this, it still would not be appropriate to leave younger savers to the "mercy" of equity index funds. There is an argument that extreme volatility could be off-putting for inexperienced young investors. In addition, relying on listed markets alone is not going to deliver the growth that people need, given they are not saving nearly enough and using AE minimums as a guide from the government on how much to save. We know 8% is insufficient, so it is up to the investment strategy to do the heavy lifting and to try and bridge the retirement savings gap. Patient capital in the form of private market investments could go a long way in helping with that. With all this in mind, it is clear to us a reduction of the charge cap would cut off DC savers from the investment opportunities and techniques they really need throughout their whole savings journey in order to optimise their retirement outcomes.

Looking at the industry, the introduction of the charge cap has trimmed any excess "fat", if there were any, and majority of pension providers are operating on thinnest margins – or aren't even profitable. The DWP and TPR should be well aware of this given the recent master trust authorisation work they have carried out. And, then we need to consider the small pots problem: their proliferation and how uneconomical they are to service. Any further reduction in charges would severely impact the industry's ability to operate and lead to a devastating collapse of the pension market, with many providers exiting all at once. Those remaining will be limited to the most basic of investment solutions, affecting member outcomes further through the lack of competition.

6. *How have investment approaches altered as a result of the introduction of the cap? What changes have there been in asset allocation, management style (active, passive, factor based)?*

The majority of DC pension schemes buy off-the-shelf solutions from asset managers to incorporate in defaults. As a result of the charge cap introduction the more expensive, more sophisticated solutions remained available to DB schemes while DC schemes had to exit them and move into cheaper, less advantageous solutions. Once again, this created an additional disparity between DB and DC investments, with the drive on oversimplification of DC. Moreover, the charge cap and the requirement to continuously assess value for money, while being good tools to protect members, pushed many decision makers into making cost their prevailing consideration when choosing pension solutions. Member value is hard to define and estimate, cost is easy to see in black and white so unfortunately a lot of suboptimal decisions have been made in the industry. Reducing the cap further will put an end to any value for money considerations in principle as there will only be one type of investment left and no comparative value assessments will even be possible. Generalising, we can say that the introduction of the charge cap has largely cut off DC savers from active investment strategies, while further reduction would affect any dynamic/smart beta/private markets approaches and leave only plain vanilla index tracking accessible.

It is also very important to understand the charge cap applies to all types of DC schemes, so there are natural differences between bundled and unbundled schemes – members in unbundled trust based schemes have the whole of the charge cap available for their investment budget, while many bundled trust and contract schemes have seen investment budgets reduced to single digits in bps terms. This is again partly driven by the small pot problem, therefore it would make more sense to address this before considering any changes to the current charge cap.

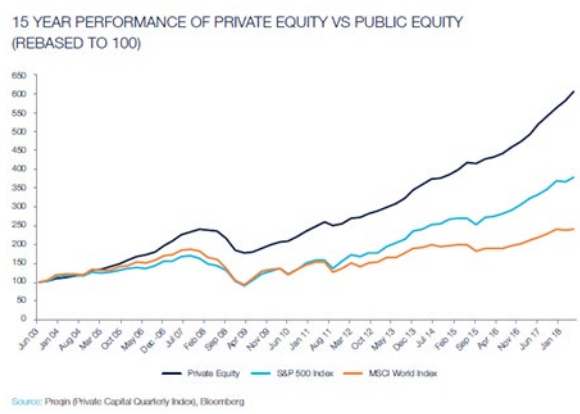
7. Have schemes changed administrator or asset manager in response to the cap?

We have seen a lot of movement in schemes switching administrator due to the cap. When the cap was introduced, many administration providers reduced the charges to the level of the cap for all existing schemes. In practice, however, this affected the investment budget which was disproportionately reduced within the overall fee.

Prior to the cap manyof DC schemes used to invest in Diversified Growth Funds which gave good diversification of the sources of return and risk mitigation, and it was particularly prevalent in pre-retirement part of lifestyles. Some of these funds were above the charge cap so schemes had to either go for simpler products from the same fund management house or move to another manager for something simpler – these charge cap DGFs were dubbed "DGF-lite".

8. What links have you found between cost and performance?

When people talk about performance, they tend to concentrate on return, but it is extremely important to remember the flip side of this – investment risk. Actively managed diversified growth funds are designed to provide consistent performance throughout all market cycles, with absolute return funds targeting a certain outcome. This is a lot more in line with how DC funds should operate, i.e. target a specific goal at an acceptable level of risk. If we look at private markets, they have consistently outperformed their public market comparators on both risk and return and after fees.



If we restrict DC savings to plain vanilla passive investments only, we have to accept the consequences – higher volatility and lower return – as volatility managed strategies and illiquidity premium will not be accessible.

9. How much notice should be given for any reduction in the cap?

Given the desire from the regulators to see consolidation in the DC market and for professionally run master trusts to become the dominant DC offering, tidying up small and inefficiently run schemes, we urge the DWP to consider the very challenging economics. Most of the authorised master trusts will take years and potentially decades to break even under the current charge cap. If this is reduced now, there will not be a well-functioning master trust market in the UK.

Part 3 - Use of combination charges

10. *Do you agree with the suggestion to incorporate new conditions into flat fee structures? If not, what other ideas do you have to address the effect flat fees can have on small dormant / deferred pots?*

We recognise the Government's concerns regarding flat fees and we support efforts to consider and address the effect of fees on savers' small dormant / deferred pots. However, on balance we do not agree with the suggestion to incorporate new conditions. While we see the argument for their introduction, we think that new conditions in the form suggested or a similar form could be detrimental for a range of reasons:

- they could lead asset managers to look to recover the lost fees elsewhere, which could result in a reduced quality of service, or a reduction in choice or value for money;
- as the consultation recognises, flat fee charging structures are helpful in times of economic stress, because flat fees are not linked to contributions or other variables and so are important for safeguarding quality of service; and
- new conditions could disincentivise savers from engaging with small dormant or deferred pots and from consolidating them.

Instead of introducing conditions on flat fees, we think the same valuable policy goals could be met through improved communication with savers about costs and charges, in order to alert savers with small dormant or deferred pots to the risk that flat fees may be materially reducing the size of their savings. We welcome industry opinions on the best approach, but our hope would be that a communicative approach would prevent any loss of quality of service, choice, or value for money, whilst at the same time incentivising saver engagement and consolidation.

11. *Should any approach to limit flat fees apply for all scheme members with a pot below certain sizes, or only for deferred scheme members? At what level should the limit apply in each case?*

12. *Are you aware of any issues that would make it difficult to implement this kind of mechanism to limit flat fees, in particular, in relation to the broader issues around the desirability of consolidating small dormant / deferred pots?*

This issue is one of our primary concerns with the suggested new conditions. Though we see the case for introducing this kind of mechanism to address important concerns around small dormant / deferred pots, we have concerns about introducing a mechanism that could be seen to benefit those who do not engage with their pensions (in the sense that savers may feel less inclined to engage with their pensions if they know protections are in place). While we believe all savers deserve appropriate protection, we fully support the industry's broader efforts to encourage saver engagement and consolidation and we have concerns that this kind of mechanism could be considered at odds with these efforts.

In addition, we worry that members who are told that these sort of conditions are being introduced may falsely assume their small pots are protected, when in fact if the conditions are similar to the illustrative examples given in the consultation, their small pots may still reduce by significant amounts over time. This is another reason why, on balance, we think that improved member communication and engagement may be a better way forward.

13. *What would be the impact on scheme members/industry?*

Part 4 - Standardised cost disclosure templates

14. Is legislative intervention required to support the uptake of the CTI templates?

In collaboration with other industry bodies and those responsible for the production of the CTI templates, we fully support initiatives designed to improve uptake of the templates across the industry. However, based on encouraging early indications of uptake and awareness, we do not think that legislative intervention to mandate use of the templates is necessarily required at this stage. We do support the Government's proposed two-stage approach, whereby as an initial stage, legislative intervention would introduce a requirement to report whether schemes are asking for and/or receiving information on the CTI templates. We hope this would provide valuable information to assist the Government in deciding whether there is a need to legislate further to mandate use of the templates.

Our general support for legislative intervention is based on our belief that widespread and eventually uniform use of the CTI templates as baseline standards of cost reporting will significantly improve the ability of schemes and savers to compare the performance of different funds and make informed investment decisions. We also hope that industry-wide adoption will stamp out some of the poorer examples of cost information provision across the industry; and a greater industry commitment to transparency and the provision of user-friendly information through use of the templates will help to improve saver engagement. We agree there are unavoidable problems with relying on voluntary adoption of the templates, not least the disinclination of some managers to report in detail where performance has been poor and costs have been high.

At the same time, we think it is important any legislative intervention includes an appropriate timescale for implementation. This is another reason why we agree with the proposed two-stage approach, as the period in which mandatory reporting is introduced will allow the industry time to voluntarily improve uptake and allow managers time to integrate the CTI templates within their systems. It will also be important for any legislative intervention to be sufficiently flexible, in order to allow more detailed cost reporting than the CTI templates require where this is available, and allow for the development of the CTI templates as more information becomes available on their use within the industry.

15. How easy is it to request cost information from asset managers?

16. *Do you believe that scheme members and recognised trade unions should have the right to request the information provided on the CTI template, and that a requirement to disclose this on request is proportionate?*

We support the suggestion members and recognised unions should have the right to request the information provided on the CTI template. The information contained on the template is a good base level of cost information which the industry agrees managers should provide in order to promote transparency and choice, and we therefore agree with the suggestion members and unions should have a right to this level of information. However, in the absence of legislative intervention to mandate the use of the CTI templates, we do not think it would be proportionate for this right to go as far as requiring that the information must be provided on the CTI templates themselves.

We support the suggestion members and recognised unions should have this right for two primary reasons:

- we are hopeful that a right in this form would encourage managers to adopt the CTI templates, as they would save time and cost with each report to members or unions if the CTI templates were already integrated within their systems; and
- we believe a right in this form would support the industry's broader goals of increased transparency and member engagement.

We think it is right that members and recognised unions have access to clear cost information that meets industry expectations, and a right to request the information provided on the CTI template is a good means of ensuring this.

17. *Should Defined Benefit (DB) schemes be required to adhere to the same standards?*

We support the prospect of DB schemes adhering to the same standards as DC schemes and welcome industry consideration of whether this should be required. However, at this stage we do not think this is as immediately required as encouraging adherence with these standards for DC schemes. Generally, we believe that implementation of these standards across both DB and DC schemes would be good for the industry, as this would significantly improve transparency, choice and ease of trustee and member engagement with investment. Given members of DB schemes have less opportunity to actively engage with investment decision-making, we do not think there is such a pressing impetus for DB schemes to adhere to these standards, compared to DC schemes, though we welcome industry views on this.

Our primary concern is that the uptake of these standards for DC schemes should not be held up by the work needed to ensure DB schemes adhere to the same standards, though we welcome the prospect of increased standardisation of cost reporting for trustees of DB schemes as well.

18. What are the barriers to using the information obtained when making decisions?