ASSOCIATION OF CONSULTING ACTUARIES

ACA response to DWP consultation on Review of the Default Fund Charge Cap and Standardised Cost Disclosure

Submitted by: Tessa Page, Chair, ACA DC Committee **Date: 18 August 2020**

What is your organisation?

Organisation:

Association of Consulting Actuaries (response on behalf of)

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?

Answer:

In summary, we do not feel there is evidence to support better member outcomes being achieved through a charge cap on transaction costs. This should however be reviewed in future as data collection and quality improves.

Advantages:

- Will potentially drive total costs down for members given increased scrutiny
- May help to set a higher bar for managers to focus only on trading expected to benefit a fund net of transaction costs
- More complete and capped costs to members can be understood in advance

Disadvantages:

- Could mean selling out of asset classes which have higher natural transaction costs, which itself may not provide strong outcomes for members in the long term
- The DWP's Investment Innovation and Future Consolidation consultation highlighted the policy desire for DC pension schemes to invest in less liquid assets. This would seem increasingly unlikely in a transaction charge cap environment.
- Could prevent investment managers from pursuing best ideas in a portfolio if incurring transaction costs becomes behaviourally seen as 'high risk'.
- Managers may hold onto assets for longer than they ideally should.
- Given transaction costs can vary significantly over time (particularly under FCA 'slippage cost' methodology) – potential to breach cap if do not include a buffer. If a buffer is implemented by schemes / pension providers, this may mean unintended consequences such as much lower effective charge cap on other elements of total charges (e.g. administration and investment management).
- Varies by type of investment – if a set limit is proposed it may be less appropriate to apply same rules to say commercial property funds (especially in UK given stamp duty) versus 'low cost' asset classes (e.g. cash funds) – may lead to unintentional consequences e.g. members / schemes pursuing investment strategies with lower expected returns in order to meet cost requirements.

- Data availability and consistency across investment managers and pension providers is better than it was at the time of the 2017 consultation, but quality remains variable and prone to error.
- FCA "slippage" cost methodology leads to "negative" t-costs in some cases – consideration should be given to how these will be dealt with.
- May limit innovation in investment design if challenges around operating a transaction cost cap and remaining below it lead to investment management houses taking a commercial decision to avoid developing DC investment solutions.

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

Answer:

Member returns

- For the reasons outlined above, it may mean investments and returns that aren't optimal, if there's a focus on transaction costs over robust investment strategies.
- If however the inclusion of transaction costs in the cap led to no behavioural change within the investment management industry, at a headline level and all else being equal, we would not expect to see any impact, given that member returns are delivered net of all costs and charges already.

Industry

- In the same way that additional fund expenses require a buffer with the charge cap, a buffer would be required for transaction costs. This would likely be larger in relative terms, given the higher level of variability in transaction costs versus annual management charges. If schemes do not use a large enough buffer, they may fall foul of the cap.
- A consistent and robust methodology for calculating transaction costs will be essential, including both how and when investment managers will be required to provide transaction costs. Currently, different providers and investment managers supply the data in different formats and at different levels of coverage.
- For asset classes that incur higher transaction costs as part of the cost of operating (notably commercial property), the cap may preclude investment managers from offering funds for DC investors.

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

Answer:

If a transaction cost cap is to be implemented we believe that this would be best delivered separately, for the reasons stated above (in particular, a combined charge cap may mean a much reduced 'non transaction cost' charge cap, given the significant variability in transaction costs).

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

Answer:

We believe that the governance and compliance duty should sit with trustees and IGCs. However, it would be more challenging for these governance bodies to control transaction costs in the same way that they are able to for investment management and administration charges. There will also need to be a duty on investment managers and pension providers to supply information in the required format in a timely manner.

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?

Answer:

Overall, we do not support lowering of the charge cap. Enhanced disclosures on charges are, in our view, already driving relatively 'high' charge schemes (even when within the current cap) to reconsider their arrangements. Charges already represent a relatively small proportion of the impact

on member outcomes, and reducing the charge cap further would, in our view, not drive additional value for money, but instead prevent further innovation and potentially reduce member outcomes.
If annual value for members assessments are concluding that value is being received at the current charge cap level, then this should be maintained, in our view.
If however inspection of these assessments (through TPR's review of Chair's Statements) points to poor value being delivered, we believe there are other mechanisms that are more effective to drive value for money, such as requirements to consider consolidation, and challenge from TPR on the Chair's Statement disclosures.
If it is not felt that the annual value for members assessments provide an efficient tool in assessing true value, it would also be appropriate to consider how these could be improved.

Advantages:
- Potential for improved competition and overall lower charges for members
- Improves in particular the "upper end" of the market from a charges perspective, where it is less likely that value for money is being delivered
- May serve as a further prompt for consolidation, if smaller schemes are unable to secure competitive terms. This in turn will drive increased value for money due to benefits of pooling, and generally improved governance within master trust and larger scheme arrangements.

Disadvantages:
- Potential for poorer outcomes for members as lower charges do not necessarily equal better value. Whilst there is likely to be some correlation between the two, this is effectively trying to solve for poorly managed and expensive solutions by controlling one variable (price). In our view the focus should be on providing quality and value for money, within a reasonable fee range.
- Reduces the potential for certain investment types and styles to be included. In particular, the use of private markets and less liquid assets, including in master trusts. These asset classes can be attractive on risk / return grounds but higher transaction costs and operational challenges in meeting a cap requirement would make inclusion difficult.
- Hinders use of active management, which could reduce future investment upside and have a knock-on impact for investment management industry, and any innovation in this space. Active investment management is increasingly used by pension schemes for ESG reasons (for example, wanting to provide a "quality filter" within emerging markets, using an active manager, in order to avoid simply holding everything in the index).
- Transitional considerations for members who are between the current and future charge cap (both for 'actual' defaults and technical defaults). This itself could incur transaction costs, moving into potentially lower quality funds if funds not available below new charge cap (as well as frictional costs such as investment consulting fees).

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)?
Answer:
Overall, we have not seen any significant issues at current level, however the cap, along with high levels of competition, has meant a focus on cost, not necessarily value.
The ACA does not provide investment products directly but anecdotally we have observed the following:
- Lower charges have in recent years been driven by high levels of competition, particularly in the master trust space, but the charge cap has also put downward pressure on fees at the 'high' end of the charging market (e.g. for smaller schemes).

- For larger providers who are already under charge cap, the charge cap itself hasn't led to significant changes in asset allocation or management style, however the overall downward pressure of fees has led to much higher levels of passive management than was historically the case.
- For well-governed occupational schemes, exploration of alternative asset classes has arguably been more limited that might have been the case absent the cap.

Asset classes with performance-based fees in particular have proved challenging (but not impossible) to operate within a capped environment.

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

Answer:

The only area where we have seen movement here is in schemes seeking to consolidate legacy bundled AVC policies which had historically higher charges.

These policies were not generally used as default arrangements and not subject to the cap per se, but the implementation of the charge cap has served to anchor a view of maximum charges more broadly.

However, administrators and asset managers have been changed in light of general pressure on DC fees and the public disclosures in this regard.

8 What links have you found between cost and performance?

Answer:

The ACA has not undertaken any in-depth research to date in this area.

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

Answer:

Given the likely operational impact and the consideration that governance bodies, administrators, providers and investment managers will need to give to the reduction, we would advocate for a relatively long transitional period, with schemes being required to report on a "comply or explain" basis during this period (under which schemes above the new cap should disclose the steps being taken in order to work towards compliance). A minimum 12 month period (equivalent to that in place when the charge cap was first introduced) would be a reasonable cycle, in our view.

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?

Answer:

We agree with the suggestion to incorporate these new conditions in light of the issues arising from flat fee structures.

That being said we do not believe new conditions will address the fundamental issue that the cost of administering small pots is disproportionate to the benefit held. Any change in conditions therefore needs to be cognisant of this fact to ensure that providers need to be able to provide strong offerings with a commercially viable fee structure. In addition, one key issue is that if flat fees apply on a defined fund value then fund value fluctuations would need to be addressed.

We note the drive to protect small pots, and therefore believe that the 'pot follows member' initiative is the most appropriate way of protecting member interests.

However, if this is not likely to be implemented, then refunding small pots (however defined) would mean that this category of generally lower paid member will at least get some value from their membership.

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?
Answer:
Given rules around active member discounts, separating charging structures for deferred members does not seem appropriate in our view.
On the wider issue of the level at which these might apply, more detailed analysis of the impact would be needed to assess a suitable level. We believe that any solution needs to be simple for members, and the issue of cliff edge impacts need to be factored in.

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?
Answer:
- Administration – anything that adds complication costs to implement, it then costs to administer and can lead to errors. We would expect the industry to adapt, but costs will/may end up being passed back to the members.
- Communications with members – anything that complicates savings risks disengaging savers and could make a member ' give up' no matter how well intentioned.
- Consolidating – having multiple potential structures would make it difficult for members to compare and understand costs.

13 What would be the impact on scheme members/industry?
Answer:
Scheme Members
- There will be winners and losers as flat fees benefit individuals with larger pots, assuming providers/employers don't meet the costs, and there is an opportunity to be seen to be fairer to low earners. Whist appreciating the intention here, we believe that the more pragmatic solution that will benefit members would be to implement pot follows members or refund small pots.
Industry
- There is potential reputational damage for the industry if the current situation continues and flat fees continue to result in eroded pots. In general we believe that that the industry will adapt to change.

Part 4 - Standardised cost disclosure templates
14 Is legislative intervention required to support the uptake of the CTI templates?
Answer:
Yes, we believe legislative intervention will be required for accurate and timely transaction cost reporting for schemes, however we do not have a strong view on whether this should be the CTI template, or another template, such as DCPT.
We do note that the DCPT reporting requirements which apply to DC schemes are different to the CTI framework, and are not interchangeable. DC schemes, under the current regime, would continue to need to report using information obtained via the DCPT template. As such, making CTI mandatory without recognising that DC schemes still have to report to DCPT standards would mean additional work and potential confusion.

15 How easy is it to request cost information from asset managers?
Answer:
Experience has been mixed to date, albeit it is improving. "Mainstream" and UK-based investment managers and providers now supply this in the requested format and on a timely basis. However, for more niche managers (e.g. small boutiques), information can be subject to delay. A range of

reporting methodologies and formats makes consolidating the information for pension schemes with multiple investment managers difficult.

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?

Answer:

Yes, however we do not propose that the information provided in the template is provided proactively to members (or recognised trade unions), as this may cause members to misinterpret the information and make decisions that may not be in their best interests (for example, a preference for cash funds which generally have low costs, but also low expected returns).

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

Answer:

On balance, we do not support a DB charge cap. However, raising the bar on governance expectations in relation to charges and fees (e.g. requiring annual value assessments) would be a constructive step.

Within DB schemes, ultimately the employer carries the cost burden and as such the direct impact on members is less evident.

Furthermore, with no “default” equivalent in DB schemes, consideration would need to be given to whether any cap would apply to scheme assets as a whole, or to different asset classes / arrangements separately.

Noting the earlier points in relation to the risks that the charge cap may limit investment innovation, such innovation is often driven first by DB schemes before “filtering” to the DC market. The introduction of charge caps in the DB world may prevent investment managers from developing solutions for the UK pensions marketplace altogether.

There is also a risk to competition. As an example, in the local government pension scheme market (where costs are constrained), the number of investment managers pitching for business has reduced over time. This also poses concentration risk as large pools of assets become concentrated with a small number of investment managers able to deliver at scale.

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

Answer:

- The lack of market framework around whether a transaction cost is higher or lower than expected, and potential actions that can be taken if transaction costs are seen as being too high.
- The significant variability in transaction cost data (including negative transaction costs).
- The differences in reporting methodology used between managers.
- Receiving timely information from managers (out of date by the time it is provided).