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Dear Sir/Madam

Response to 'Better workplace pensions: a consultation on charging'

We are writing with our response (attached) to your consultation document on the above.

Members of the Association of Consulting Actuaries provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members advise schemes covering the majority of members of private sector defined benefit and defined contribution schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

We hope you find this response helpful. If you wish to follow up any points, please contact me on paul.macro@mercer.com

Yours sincerely

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Response to 'Better workplace pensions: a consultation on charging'

Transparency and disclosure

1. We would welcome views and evidence on the effectiveness of these initiatives and the extent to which the industry discloses charges upfront, in a consistent manner, to members and employers.

The providers that are actively marketing DC products are generally offering products with only a single price (ie Annual Management Charge (AMC)). This is mainly as a result of the launch of Stakeholder in 2001. This has provided consistency in the phraseology used in explaining charges, even if this is not always understood by members.

The AMC is a term that is thought to be understood by employers and trustees, and almost always quoted to members. Total Expense Ratio (TER) is also now accepted as a term to express charges, but unlikely to be understood as well, by members.

Whilst both the AMC and TER are generally quoted to members, the actual charges and costs included within each are not consistent or clearly communicated. This can make it difficult for advisers to accurately compare scheme charges and, therefore, determine value for money in the proposition, let alone enable a member to have confidence that the charges being incurred are providing the best possible outcome.

Providers' charges for modern DC products are generally determined through sophisticated pricing models, enabling providers to quote competitively on a scheme by scheme basis. The fund management costs that are used to calculate TER in particular are not as clear and providers themselves often have difficulty in obtaining consistent information from fund managers to enable them to effectively quote TER on a consistent and comparative basis. This impacts the ability of the provider market to accurately and consistently quote overall charges.

There are additional problems in explaining to members (and also, to an extent, trustees and employers) the variable nature of the TER and hence the potential impact on member funds.

Providing employers, trustees and ultimately members with a single figure that includes all the charges a member will pay from their funds is important so comparison between products, providers and investment managers can be carried out effectively. Currently, the industry is using the TER as a proxy for this despite its limitations.

There are still those products established before 2001, particularly Group AVC arrangements, that have a far wider range (and level) of charges that make it difficult for members, employers and trustees to understand the type and level of charges that are being deducted. Even after the advent of Stakeholder, a number of providers continued to offer Group Personal Pension and trust based occupational schemes (e.g. CIMPS) that used older charging models.

The joint industry code of conduct on disclosing pension charges and the separate ABI agreement have been successful initiatives in raising the issue of communicating charges effectively to employers and members respectively. Both initiatives have tackled the issue of disclosing charges consistently and enabling clearer comparison of costs.

Similarly the IMA enhanced disclosure of fund charges and costs has set out to define the different costs incurred in managing a fund. This has been referenced as the source for defining the transaction costs in both the joint industry code of conduct on disclosing pension charges and the ABI agreement, which is a positive step towards achieving transparent and consistent disclosure of charges.

However, all three are simply industry initiatives that do not need to be compulsorily implemented. Even where the initiatives are implemented the time scales for producing the documents are not hard deadlines for complying.

The initiatives are also limited in their remit. The ABI agreement in particular is only applicable to contract based arrangements.

The three initiatives focus on the charges and costs, which quite rightly need to be defined and consistently disclosed. However, there is an over emphasis on the actual charges and a lack of focus on identifying value for money. The joint industry code of conduct on disclosing pension charges goes some way to tackling this aspect by providing a high level overview of services, but this is limited and likely to result in employers concluding that the provider market is homogenous if any comparison is made.

Making decisions based on comparisons of the charge alone could result in a worsening of member outcomes. For employers and trustees it is essential that transparent and consistent disclosure of charges and costs is utilised within a wider analysis of services based on their specific requirements, both at a corporate and member level.

2. Is further action required by the Government to improve disclosure and if so which of the options should be introduced? Are there any other options?

Additional detailed disclosure directed at members needs to be balanced against the danger that it could well confuse members and ultimately act as a disincentive to saving for their retirement

Also because members have no choice when it comes to selecting the scheme for automatic enrolment it is questionable as to whether such disclosure would result in a positive outcome. We therefore believe that any member-directed disclosure needs to be tackled within a much wider remit encompassing retirement requirements and education.

The various initiatives in charge disclosure to employers are an important and significant starting point. They are, however, only a guide to best practice and there is no compulsion to implement these initiatives consistently. Further guidance and definition from Government and regulators would aid in implementing consistently the three initiatives published by industry bodies.

However, a single piece of legislation enacted by the Government utilising the initiatives already defined by industry bodies would ensure that providers and fund managers consistently disclose charges and costs. This does not though tackle the lack of alignment that has been highlighted between the interests of the employer who selects the arrangement (and whose focus is often on minimising costs and administrative implications to itself) and the interests of the members. We therefore think that some consideration ought to be given to encouraging all employers to consider member outcomes as one of the factors in scheme selection and review, though the details of this are perhaps outside of this consultation.

3. How might the total cost of scheme membership including transaction costs be captured, what would be reasonable and practical to ask providers and investment managers to report on and to whom (members, employers and governance committees/ trustee boards)?

It is essential that charges and costs are captured consistently to enable better comparison and identification of value for money in the recommendation of an employer sponsored scheme, as well as monitoring of on-going suitability. Defining the charges being disclosed will also provide greater transparency, leading to increased competition and confidence that the value in members' retirement pots is not being reduced through hidden (and excessive) charges.

However, the way in which charges are disclosed must be targeted appropriately at the intended audience. Providing members with excessive detail on the charges will confuse and even potentially act as a disincentive to saving for their retirement. Equally, providing too little information to employers and trustees will prevent them from making an informed decision on the value being provided.

The terms Annual Management Charge (AMC) and, to some degree, Total Expense Ratio (TER) are well used within the industry and in communication with employers, trustees and members. The key issue is in knowing exactly what charges and costs have been included in each.

The terms AMC and TER need to be formally defined, including clarification on the types of charges and costs that are reflected in each of the terms, which would also be consistently defined.

The AMC should quite clearly indicate those charges that are known and fixed, for example the administration and the fund management costs.

The basis of the term TER should continue to encompass both those charges disclosed within the AMC and those charges that are variable and generally defined by the IMA enhanced disclosure of fund charges and costs. The TER should include all charges such as transaction costs, Stamp Duty, Reserve Tax and performance fees. Essentially any costs, charges or deductions from the fund should be included in the TER, although it is recognised that the way in which certain charges are reflected needs further consideration.

An alternative term to express the TER might though aid in communication with members, employers and trustees and we recommend that this be the subject of some additional research before terminology is legislated for.

As the TER is variable, all charges should be calculated and disclosed to trustees or governing bodies on say a quarterly basis using a rolling twelve month period. In addition, and where charges for a twelve month period are not known, the anticipated maximum charges that could be taken should be disclosed within the TER, excluding set-up fees for a new fund.

The level of charge data contained within AMC and TER figures would provide significant information and transparency, enabling greater comparison between providers. This would enable employers and trustees to more easily derive value for money when combined with detailed analysis of the provider propositions, either during initial selection of a provider, a provider review or as part of on-going governance.

However, providing this information as an extensive list of charges (including transaction costs) to the average member would be bewildering, lead to confusion and possibly encourage negative outcomes such as increased rates of opt-out. The charges should, therefore, be summarised as a single total charge.

Annual benefit statements should need to continue to set out the total charges at the point of production.

It is essential that illustrative material produced for members does not focus purely on charge alone. Providing information that just illustrates the impact of charges could encourage negative member outcomes as much, if not more, than the provision of too little or too much detail on charges. Members need to be able to see charges in the context of value for money. This is most easily achieved and communicated at member level through clear and concise performance information, for example by using a personal rate of return, alongside the objectives of the investments, contributions that have been made and total charges.

Charge cap options

4. Do the proposed implementation dates for a cap provide sufficient time for employers to review and put in place compliant arrangements? The dates are:
• April 2014, for all employers staging from April 2014 onwards.
• April 2015, for all employers who staged between October 2012 and March 2014.

We do not consider that April 2014, for all employers staging from April 2014 onwards, provides sufficient time as the volume of cases is simply too large. The Government impact assessment refers to 90,000 schemes that would need to be re-priced.

Such a change would be impacting at a time when provider and adviser resource capacity is already strained, dealing with preparation for 2014 stagers and providing an acceptable continuing service level for clients who have already staged.

In particular the pricing reviews will need to draw on the provider pricing teams which are relatively small teams of specialised individuals. We do not believe it would be practical to significantly increase the resource available within these teams especially at short notice.

Some schemes will need to appoint a new provider, many others will wish to review the market. The timescale to both select a new provider and implement the new arrangement is normally around 4-6 months. Any reduction in implementation timescales would lead to significantly higher operational risk and potentially poorer decision making.

The ABI legacy schemes review (to be undertaken during 2014) will confirm that some arrangements contain:

- highly valuable investment and/or annuity rate guarantees
- front loaded charging structures that are not appropriate for new members but are potentially very good value for existing members
- penalties for ceasing contributions such as charges and/or loss of investment guarantees

It could be detrimental to some or all scheme members' best interests to insist that the ongoing contribution flow is redirected from the existing product into a charge capped product.

Until the conclusion of the ABI legacy schemes review, there is a material risk of any earlier repricing and any Government proposals being unsustainable. Whether any revised charging requirements can be decided, and implemented by April 2015 needs further consideration.

5. Which of the three options for a cap is the most appropriate?

The combination of banning consultancy charges and commission, together with the review of legacy schemes will remove most sources of high charges, so there may be a case for arguing that an overall charge cap is not required.

If a charge cap is to be imposed, then of the options being consulted upon we believe that option 3 is the most appropriate. Circumstances under which we believe it is appropriate to charge more than 0.75% are covered in our response to question 6.

However we believe that it will be critical to clearly define the charges to be included in, and particularly those that can be excluded from, the charge cap calculation. It would also be beneficial to align as far as possible the definition of charges used within the charge cap calculation with the charge definitions used for disclosure i.e. either AMC or TER.

Since the introduction of the stakeholder charge cap, new pension schemes of all types have typically been implemented with charges lower than 1% of funds under management. However, the 1% charge cap only became affordable due to:

- advances in IT allowing for the adoption of efficient automated processes
- the increased use of passively managed investment approaches

Whilst we have seen continued improvement in operational efficiency within the pensions industry since the introduction of Stakeholder, this has been offset to a large extent by additional expectations on providers in terms of extra services to members such as enhanced communication materials, web access and tools and indeed auto-enrolment implementation and operations. It is therefore not clear how a significant reduction in charges from the current cost model could be achieved.

In addition, there has been a significant reduction in the number of pension providers since the introduction of the stakeholder. This has resulted in the withdrawal of some of the less efficient providers from the market. However it is not clear that a further significant reduction in choice would be beneficial.

6. Under option 3, what conditions would you expect for schemes levying a higher charge between 0.75 per cent and 1 per cent?

Historically there have been four main components of charges; operational, investment design, investment charges and adviser remuneration. We will comment on the commission proposals later in our response.

***Operational Charges*:** It is not clear that the introduction of a charge cap would have a material impact on the operational charges taken by pension providers for modern contracts. Competition has been successful in driving down the operational element of charges at least from a new business perspective. We do not believe that operational elements by themselves are likely to justify scheme charges over 0.75%.

***Investment design*:** The charge cap could, though, have a significant detrimental impact on investment design. One of the impacts resulting from the introduction of the Stakeholder charge cap was a drive towards the use of passively managed investments particularly within the default arrangement. With the growth in DC assets since then, consideration should also be given to whether any charge cap driving a further move to passive investments over a short time frame could impact on the markets. In the longer term it also very likely leaves little or no room for consideration that active management could have the potential to provide a better return albeit at higher cost.

In our opinion, for the investment design component, a greater focus should be placed on improving eventual member outcomes net of charges. We agree that charges have a significant impact on member benefits, but improved investment performance can be significantly more important than charges in driving successful member outcomes.

We believe that funds designed to consider both expected returns and the volatility of the returns, such as diversified growth funds, should be considered during the growth phase of the default investment strategy. The market has already demonstrated that these funds can be constructed for a modest additional cost.

In addition the ongoing debate on the appropriateness of member retirement options is likely to lead to the need for more sophisticated pre-retirement fund options, which may require higher charges.

***Investment charges*:** To date, the level of the charges made by investment managers have not typically been separately disclosed within the overall AMC. We believe that this has potentially acted as a barrier to competition.

In summary, we believe that the base scheme charges to cover specified core operational or administrative services and passively managed investment options could almost always be 0.75% or under. However, it should be allowable to design default investment designs, including actively managed components in the accumulation and pre-retirement phases, with anticipated improved member outcomes and a cap at this level may restrict this.

7. How will employers and pension providers respond to a cap on charges and what evidence is there that charges will be 'levelled-up' in response to a cap?

There is always a danger that change introduces opportunities for price increases. However, the experience within the pension industry following the introduction of Stakeholder was for an overall reduction in charges, and enhancements in the available IT at that time facilitated this.

If there are sufficient providers in the market we see no likely change in this. The concern is that a material reduction in the number of providers as a result of the introduction of a charge cap would result in significantly less competition, increasing the probability of "levelling up".

Employers are less likely to hold a strong view, provided the charges remain reasonably competitive, but any increase has potential employee relations consequences. A competitive charge strengthens their benefit package, but it is unlikely to be a huge driver especially as the charge cap would ensure that charges would not be excessive.

8. What evidence is there on the link between scheme charges and scheme quality or investment returns?

This is inevitably subjective to a great extent. For example in some circumstances schemes can access better support for their member engagement strategy with a provider whose charges are marginally more expensive than other options. Other respondees are better placed to comment on the likelihood or otherwise of improved investment performance as a result of paying additional charges.

9. If a cap is introduced, what if any changes should the Government consider in respect of the stakeholder charge cap?

We believe that any charge cap that is introduced should also be applied to default funds in stakeholder arrangements that are designated as 'qualifying workplace pension schemes' or QWPS.

However, the stakeholder charge cap applies to all funds within the contract and not just the default investment. This could be one of the deciding factors when considering adopting a stakeholder rather than a GPP arrangement and we therefore believe that the existing Stakeholder rules should remain in place for the alternative fund options

We would however encourage consistency in charge definition between the new charge cap and the stakeholder cap.

10. Are there any alternative options to capping charges that would provide protection for scheme members?

In terms of formal fee protection, there are no other obvious options available that will offer the same level of protection as a charge cap.

One alternative approach could be the implementation of appropriate compulsory disclosure of charges on consistent bases, to enable appropriate comparisons by members, employers and trustees. The Pensions Regulator could collect such information from schemes in the annual return. If they were able to use this information to determine that charges were at inappropriately high levels, then charge capping could be introduced and the data collected could be used to determine the level of such a cap.

Other possible solutions would be a mandatory scheme review to consider terms, proposition and competitiveness. For example:

- requiring regulated advice to employers on the selection of pension arrangements, including advice on contract-based arrangements and master trusts

- requiring mandatory governance arrangements to be put in place by scheme sponsors, including a regular market review requirement. Alternatively this could be restricted to schemes where charges for the default investment exceed 0.75%.

11. What impact will a charge cap have on the capital reserves pension providers need to hold under:
- *A 0.75 per cent or equivalent cap?*
- *A 1 per cent or equivalent cap?*

We believe that the insurance industry is better placed to respond to this question.

12. Should transaction costs be included within a charge cap?

We do not believe that transaction costs should be included within the charge cap. We believe that there should not be an artificial barrier to trading, when the trading is carried out with the intention of improving member outcomes.

However, there are other additional costs currently imposed on funds outside of the annual management charge that are not linked to transactions, for example audit and custodian fees. We believe that all other costs within the fund structure that are not directly incurred as a result of trading should be included within the cap (and within any disclosure of investment costs within an overall AMC).

Consideration will need to be given to the conversion of non-fund related charges within the application of the charge cap. Will a scheme level calculation be required to convert contribution related charges into a percentage of fund equivalent?

We believe that it is critical to obtain a clear unambiguous definition of charges in order to operate a charge cap affectively. We also believe that there are clear benefits in adopting as consistent an approach as possible between the charge disclosure requirements for individuals and for trustee / governance groups and the charge definition adopted within the charge cap.

13. Would requiring the disclosure of transaction costs to trustees and the independent governance committees to be set up for contract-based schemes help to manage any potential avoidance risks associated with a charge cap?

We welcome any initiatives to improve disclosure on charges to trustee and governance groups.

Any scrutiny that is applied can help to identify potential abuses, however we would question whether any one scheme has sufficient influence to affect change within the investment management sector.

We believe that it would be far better to rely on a clear set of definitions within the legislation covering terms like transaction costs that can then be verified through the audit process to ensure that only genuine transaction costs are being excluded.

14. Are there any specific services that may need to be excluded from the cap to avoid constraining innovation, for example, in respect of annuity broking services?

The likelihood of investment innovation and more structured products or options being developed will become less likely the lower a cap is set, as it will drive down any ability for volume or deployment of many of the new (or future) solutions that might otherwise be developed. Costs for these initiatives may need to be specifically excluded from the cap if they are to be developed further eg under Defined Ambition.

In general, we believe that any list of exemptions should be kept to a minimum and only for services where there is a proven benefit. Consistency in measuring what is excluded from any cap will be essential.

Active member discounts

15. What would the impact be of a ban on Active Member discounts and other arrangements where deferred members pay an increased charge in qualifying schemes, would providers need to increase charges for active members and if so, by how many percentage points?

The impact of a ban on AMDs would be an immediate increase in charges for active members of schemes already operating this type of arrangement. We understand that since the publication of the OFT report, providers are no longer quoting for new schemes on this type of arrangement and therefore the ban would only impact schemes already established on this basis.

The level of increase for active members will depend on a host of factors, including:
- The current differential pricing between active and deferred members
- The current level of active and deferred member charge and how these compare to the proposed price cap.

We would expect that the new level charge would be somewhere between the active and deferred charge, but is likely to be at the higher end of the middle pricing point. This reinforces in practice the principle that an AMD is not just an increased charge for leavers, the employer (usually with assistance from an adviser) secured preferential pricing treatment for members of their scheme whilst active employees of the company.

We would have the following concerns of such an immediate ban:
- Active members would be immediately penalised with higher charges. We believe this would be particularly unfair where the current active member discount arrangement gives deferred members a charge which is already within the proposed lower price cap of 0.75%.
- Communicating higher charges to active members has the potential to further damage an individual's trust in pensions and saving for retirement

- Providers' resources are already being stretched dealing with auto-enrolment. We do not believe the providers would be able to re-price schemes to remove active member discounts on an individual basis. They are likely to take a wholesale approach to re-pricing which is unlikely to be in the best interests of members generally.

16. What, if any, transitional arrangements might be needed for those schemes already set up?

Transitional arrangements should be considered for two distinct categories of arrangements as follows:

a) For schemes operating an AMD whereby the deferred member charge is within any price cap:

We believe that extending the price cap to deferred members of a qualifying pension arrangement would be sufficient in itself to protect individuals from excessive charges. We therefore believe that arrangements already in existence whereby the deferred member charge is within the proposed price cap should be able to maintain an Active Member Discount for an indefinite period. This would avoid the need to unnecessarily increase charges for active members of such arrangements.

b) For schemes operating an AMD whereby the deferred member charge is in excess of the proposed price cap:

In our experience, these arrangements are also likely to be established on a commission basis and therefore any decision on commission and associated transitional arrangements should be considered together.

However, we understand that there may be a small minority of arrangements established with unreasonably high deferred member charges and therefore consideration should be given to imposing at least a stakeholder charge cap for deferred arrangements. When re-pricing any arrangements that do not meet these minimum criteria, it would be preferable for any future commission to be reduced or eliminated before any increase in the active member charge.

Any price cap imposed above should apply to the equivalent charge for members investing in the default investment fund rather than their actual chosen investment. This would avoid penalising individuals who have chosen to invest in more active sophisticated fund options.

17. Can you provide more information about the scenario whereby employees who leave their job are converted into an individual personal pension? Does this require the member's consent and is this practice disclosed to employers when they choose the scheme?

Other respondees are better placed to comment on this item.

Consultancy charges

18. How are the existing regulations working in practice and how are services now being delivered and paid for?

The short lifespan of consultancy charging (CC) means that it is not possible to draw any conclusions from that charging mechanism.

19. How are charges for blended funds structured, their level set and what disclosure is in place for members and employers?

Other respondees are better placed to comment on this item.

20. What impact would extending these regulations to qualifying schemes have on providers, employers, advisers and any other third parties, and what if any transitional arrangements would be appropriate?

Other respondees are better placed to comment on this item.

Commissions

21. What would be the impact of a ban on commissions in qualifying schemes and does commission present a barrier to switching?

The ban on commission in qualifying schemes will have a significant impact on the market. The number of companies providing pensions advice to employers would likely reduce as some of the smaller organisations may be unable to, or may choose not to, continue. The number of individuals in larger organisations may also need to reduce for these organisations to align service provided with income received. If there was to be such a reduction in advisers then there may be a large capacity issue with employers being able to source advice for auto enrolment and on-going management and employee engagement.

If there was to be a period of grace whereby commission could continue to be paid then more advisers would be able to assist with the success of auto enrolment. It would also allow time for advisers to agree future remuneration agreements with their clients. Companies would have time to budget for what fees and services they desire.

If commission was removed from existing schemes then many employers would invariably reduce the scope of services or expect the provider to take on the services that were previously taken on by the adviser.

22. What evidence is there of an increase in sales of DC schemes with commission in 2012?

Other respondees are better placed to comment on this item.

23. How much (on average) has commission on these schemes increased the AMC in percentage points?

Other respondees are better placed to comment on this item.

Response by:

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