Response by TISA to DWP Call for Evidence: Review of the Default Fund Charge Cap and Standardised Cost Disclosure

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About TISA

The Investing and Saving Alliance (TISA) is a unique and rapidly growing membership organisation. Our mission is to work with our industry members to improve the financial wellbeing of all UK consumers to **deliver practical solutions** and devise innovative, evidence-based strategic proposals for government, policymakers and regulators that address major consumer issues.

TISA membership is **representative of all sectors** of the financial services industry**:** We have **over 200-member firms** involved in the supply and distribution of savings, investment products and associated services, including the UK's major investment managers, retail banks, insurance companies, pension providers, online platforms, distributors, building societies, wealth managers, third party administrators, Fintech businesses, financial consultants, financial advisers, industry infrastructure providers and stockbrokers.

Complementing our development of consumer policy and commitment to open standards and governance, TISA has become the **pre-eminent membership body for the delivery of digital industry initiatives**, including:

- **Open Savings & Investments -** a fundamental component of Open Finance which will enable our industry to become fully digitally enabled
- **Digital ID** - enabling easy access to all digital services by creating a single, reusable, secure ID owned and controlled by the consumer
- **TISAtech -** the new generation digital marketplace connecting Financial Institutions with FinTech's
- **TISA Universal Reporting Network (TURN) -** an industry-designed blockchain data solution for the collection & dissemination of EMT data

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Executive Summary

TISA welcomes the opportunity to respond to the Department for Work and Pensions Call for Evidence: Review of the Default Fund Charge Cap and Standardised Cost Disclosure.

It is important to undertake reviews of this nature periodically to ensure that original policy intentions are functioning as intended and still providing good consumer outcomes. The impact of market maturities and external factors can produce unexpected results and it may be necessary, at certain times for changes to mitigate these.

Given the high percentage of scheme members in their default investment strategy, the concept of a charge cap was an important introduction to ensure both a broad charge consistency exists amongst DC workplace pension schemes and that the level of those charges are capped at a reasonable level.

There is a current Government and Industry desire for DC schemes to widen investment into the illiquid landscape, including smaller/unlisted firms, infrastructure, property and green initiatives. These investments are typically more expensive to invest in and many DC schemes have struggled to access these markets due to cost constraints. As workplace pension scheme saving matures, some schemes are now achieving the scale to allow them to diversify into these areas. A lowering of the charge cap (either by including transaction costs or reducing the cap) may result in this additional constraint preventing those schemes from accessing these markets.

The current charge cap is at a level which permits providers to invest in their schemes to enhance Value for Money (VfM) for scheme members, through enhanced online propositions, better service and product innovation. This will help increase public confidence in pensions and enables the Auto Enrolment (AE) market to grow into a strong, well-funded and governed industry which protects the money of its members.

Transaction costs cannot be avoided and whilst not currently capped, it is encouraging to see that there has been no evidence found of these being excessive. Aside from the charge cap, workplace schemes have an additional layer of governance in place in the form of the Scheme Trustees and IGCs. These are responsible for ensuring that schemes are offering VfM to their members. If transaction costs are excessive, then it is the responsibility of these boards to challenge the providers/fund managers and take appropriate action. A cap on transaction costs could lead to sub-optimal consumer outcomes and further constrain investment and product innovation – the details of which are set out in our response.

Whilst the level of charges is an important factor to consider, we shouldn’t lose sight of the bigger picture which is the VfM that a scheme provides to its members. Charges are one of the factors in what determines VfM but there are several others to consider at the same time, including net fund performance, the product proposition and online capabilities. Reviewing charges in isolation may lead to poor consumer outcomes.

We recognise the growing issue of small deferred pots within AE and agree that the fee structure needs to be reviewed for these pots, to ensure funds are not eroded before retirement. However, the fundamental problem to resolve here is the growing number of these. If Government and Industry can jointly arrive at a practical solution to this increasing challenge, the issue of the charging structure for these pots largely falls away. ‘Pot Follows Member’ was a previously proposed solution, which is worthy of a revisit.

To summarise, we believe the cap is still fit for purpose at its current level. Combining this with the governance of the Trustee/IGC provides an effective framework to ensure that transaction costs do not become excessive and allows providers some leeway in driving forward innovation to benefit both consumers and the Industry.

QUESTION RESPONSES

POTENTAL CHANGES TO TRANACTION COSTS

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

We do recognise that a cap on transaction charges would ensure that transaction costs do not become unnecessarily high. This could be considered an advantage, however we note that there has been no evidence of this practise taking place to date. We would also expect that the existing governance structures put in place, ensure that should this become apparent, it would be challenged by the IGCs and Trustees with appropriate action taken. For clarity, 'excessive charges' should be measured by the volume of transactions undertaken and the resulting investment performance.

It is worth clarifying that transaction-costs are not a fee that goes to the asset manager, they are a cost incurred in the course of portfolio management. Performance of a particular investment is always stated net of costs. Managers are therefore incentivised to keep these costs to a minimum and to trade in line with best execution practises.

Extending the cover of the charge cap to include transaction costs in effect reduces the limit of the existing cap. The consultation document outlines some of the concerns which we have in this area.

There is a drive and desire within Government and Industry for DC pension schemes to look at more sophisticated and diverse investment strategies which could enhance member outcomes - in particular to consider illiquid assets and infrastructure. Fund management and transaction charges for these investments are typically higher due to their nature as they require active management and there could be significant set up costs around R&D and supporting operational and governance structures. Many DC workplace schemes currently struggle to access these markets due to existing cost constraints. As the AE market starts to mature and following a period of consolidation. some workplace DC pension schemes may now be close to achieving the scale to enable the consideration of incorporating these funds within their default strategies, however a reduction in the charge cap will constrain their ability further and the opportunity may be lost until the AE framework becomes more mature.

Transaction costs cannot be known in advance – market activity and investment strategy will determine transactional requirements, with both implicit and explicit costs subject to variances over time. In order to comply with a charge cap which includes an unknown and variable cost, schemes will need to be prudent with their assumptions and err on the side of caution. This means the portion of the cap which accounts for administrative and investment charge components may be reduced to a lower level than they need to be. The outcome of this may be that default strategies are constrained by more than they are today, typically moving away from; asset classes with higher transaction costs/active security selection/active asset allocation/portfolio rebalancing, all of which are designed to produce better outcomes. In addition, placing a cap on the transaction costs may lead to fund managers unable to transact at a time when it would lead to better consumer outcomes.

The charge cap is there to protect consumers and ensure that there is a broad consistency between providers operating within the AE framework. However, charges are only one piece of the jigsaw which constitutes VfM. Charges cannot be considered in isolation and a more holistic review needs to be undertaken to look at the other aspects which create the whole proposition including administration standards, online capabilities and net fund performance.

An effective reduction in the charge cap would restrict the ability of schemes to boost their propositions which include product, investment strategy and online service innovation. As the AE market matures and assets under management grow, we want schemes to be strong and well-funded propositions, which provide security for members and increase public confidence in the pensions industry. IGCs and Trustee boards should be ensuring that the schemes offer good VfM and be challenging where this does not appear to be the case. This should include where transaction costs levied by the fund managers appear to be excessive. The existing charge cap combined with strong governance through the frameworks that have been put in place should be an effective mechanism for ensuring that VfM is achieved, which in turn means that good consumer outcomes are reached.

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

As mentioned in our response to Question 1, a cap on transaction costs would result in additional constraints being placed around the sophistication of the investment strategies which has the potential impact of hampering better consumer outcomes.

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

If it is decided that transaction costs should be capped, then these should be kept separate, however both approaches create significant challenges for impacted parties and it should be considered whether some form of benchmarking framework is put in place to assist Trustees and IGCs in this regard.

A separate cap would place the onus on asset managers to comply: this would encounter difficulties of a) what happens if a default is constructed from funds run by various managers; and b) what happens in a situation where a manager is halfway through the year and runs up against the cap?

If the trustee has to comply, they have the issue of trying to manage a cost they do not control, and which will vary year-to-year. The impact of this is to put further pressure on the fee space available for default investment options.

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

It is the fund manager who performs the transacting and therefore has responsibility for ensuring the associated costs remain within the cap. The IGCs and Trustees have the responsibility for ensuring that transaction costs are not excessive and challenge the fund managers where appropriate.

The composition of some default strategies relies on funds being administered by more than one fund manager. An introduction of a transaction charge cap for this structure will be complicated to manage and further highlights the complexities that may be involved in controlling costs.

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THE LEVEL OF THE CHARGE CAP

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

The impact of a lowering of the cap, either through a reduction in the existing level or through the inclusion of transaction costs have largely been outlined in the earlier question responses including aspects around investment constraints and the hampering of better consumer outcomes.

It is also worth noting that the introduction of the cap has led to a strong focus on costs, rather than considering the more holistic picture of outcomes. A lowering of the cap could exacerbate this.

We need to be mindful that a cap reduction cannot be incorporated by simply reducing the level across the board and continuing with business as usual.

Providers will need to review their business models and review all AE schemes in operation to determine which would still be viable to administer under the revised cap and which would not be. For those employers and schemes which are no longer viable to service, arrangements would need to be made for them to be transferred away to a new provider which would accept their business, or alternatively move to NEST. This could result in further scheme consolidation taking place.

As ESG rightly becomes more embedded within pension schemes investment considerations and strategies, the associated costs involved may be an additional factor which constrains schemes to meeting a charge cap which is effectively lower than it is today. This may impact on the sophistication of the ESG strategies that can offered within scheme defaults.

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)?

Within the DC market, the cap has restricted the ability to invest in a wider range of asset classes such as infra-structure, property and patient capital. There has been a move within some strategies to switch to tracker funds.

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

There has been a high focus placed on charges when a change of provider is considered by employers. This can be the overriding factor as this is an easy metric to compare, however we hope that in most cases other factors are also considered and decisions are based on VfM. Whilst the cap has ensured firms have met the requirement and remained within this level, it is difficult to determine whether existing default fund charges are as a direct result of the cap or include the consumer benefits derived from market competition.

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

We have no evidence to provide but recognise it is crucial that we continue to work towards better client communications, where details such as costs and performance can be presented in an understandable and transparent way.

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

We outlined the impact of a cap reduction and work involved for providers in the answer to Question 5. In addition, as some schemes would be deemed non-viable, time would be needed to allow employers to find an appropriate alternative provider, set up a scheme default, agree costs and arrange for the scheme transfer which would include employee communications and possibly employee seminars and/or 121 sessions. Given the impact on business of recent unprecedented events such as Brexit and COVID-19, we need to provide them with appropriate timescales to meet these additional requirements. We consider this to translate into a cap reduction date of no earlier than April 2023.

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 are aware of the growing issue that deferred pots is creating within AE, which has an impact on both providers and members. COVID-19 will exacerbate this issue with the raft of redundancies that are resulting from the fallout. We agree that the fee structure and level which apply to deferred pots needs to be addressed to ensure that that these pots, particularly when of a small value are not completely or nearly extinguished before retirement is reached. It is important not to add too much complexity to any solution, as these changes need to be communicated to consumers, many of whom already struggle to understand charges in provider communications.

The proliferation of small pots and the expected increase over the coming years is the fundamental problem however, which needs to be addressed. We need to be mindful that any change to the fee treatment of small deferred pots does not disincentivise consolidation, where a favourable fee structure removes the inclination to move a deferred pot to another pot which incurs higher fees. A balanced approach is required to achieve the desired outcomes.

TISA would welcome the opportunity to participate in a Government/Industry initiative with an objective of resolving the significant challenge of deferred pots. 'Pot Follows Member' was a previously proposed solution, which is worthy of a revisit.

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?

We believe any fee restriction should only apply to deferred pots. Active pots should accrue funds above a deferred pot fee threshold fairly quickly. Resolving the deferred pot issue will also reduce the need to apply this to small active pots.

The threshold and fee structure which applies should ensure that that these pots are not completely or nearly extinguished before retirement is reached.

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?

A tiered flat fee structure based on fund value creates some administrative challenges, in particular where a pot is close to a fund threshold and regularly falls in and out of different fee brackets.

As included in our response to Question 10, we need to be mindful that consolidation of small pots is the ultimate goal for the benefit of consumers and Industry. A fee approach needs to strike the right balance and requires the collaboration of Government and Industry to formulate a workable solution which benefits everyone.

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

Depending on the nature and level of a deferred pot fee restriction, schemes with a high proportion of deferred pots will be hit hardest, which may lead to a change in fee structure for active pots in order to mitigate some of the impact..

Members will see their deferred pots eroded less quickly and this may create more confidence generally in the UK pensions system.

The biggest consumer benefit would be generated through a resolution to the growing small pot challenge.

STANDARDISED COSE DISCLOSURES

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

No, we do not believe that legislation is required at this stage. The template has had a relatively high uptake within the industry and there are other templates such as the DC Workplace Pensions template which are also in use and achieves similar outcomes. Should it become apparent there are widespread issues in this area, legislation would be a consideration at that time.

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

We have no evidence to provide in this area.

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?

The information contained within the CTI template and others should be included in scheme governance reports and is available to view, should trade unions and members require this detail. It is worth noting that it is highly unlikely that most scheme members would be interested or aware that this information exists. A wider level of interest would exist around how the scheme is performing generally and the VfM it is offering to its members.

17. Should DB schemes be required to adhere to the same standards?

We do not see why there should be inconsistencies between DB and DC in this area.

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

We are not sure who the decision maker is envisaged to be in this question, however whether that is the trustee/IGC/member/employer, any decisions should not be based on costs in isolation, as this can lead to poor member outcomes. Other aspects of the scheme including service standards, online propositions and net fund performance should be considered when assessing its suitability for the membership.