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Pensions Investment Review: Unlocking the UK pensions market for growth

Response from the PMI

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Response to the DWP / HMT Consultation "Pensions Investment Review: Unlocking the UK pensions market for growth"

Introduction

The PMI is the professional body which supports and develops those who work in the pensions industry. The 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 7,500) 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.

The 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.

We are pleased to respond to your "Unlocking the UK pensions market for growth" consultation and recognise that this is a very important consultation since the proposals would radically alter the UK pensions landscape.

We further recognise the Government's interest in using pension scheme assets to help drive growth in the UK economy for the wider societal good. However, we strongly believe that the case for pension assets being used this way is not yet conclusive, nor do we believe that it follows logically that larger schemes will automatically invest more in illiquid assets and private markets, and certainly we do not see any reason to assume that any such investment would happen in the UK. Therefore, trustees current fiduciary duties towards their scheme members should remain their primary concern when making investment decisions.

Productive Finance assets could have a place in a diversified default strategy as an alternative asset class, and should be more readily available for DC pension schemes for that purpose. But they should only be one of several possible options to be considered in the overall "investment toolkit". We also believe that "Productive Finance" needs to be better defined, if your proposals go ahead.

Our detailed answers to your questions follow but we draw your attention to the following points in particular:

- We believe that providers should continue to apply differential pricing for different employers based on projected administration costs.
- The question of whether there should be a duty on employers to assess the value of their pension offering has many different aspects to consider. On the one hand, employees should have confidence that their employer has chosen a pension arrangement for them which offers good value – not just the lowest cost. However, on the other hand, any such duty will add to the cost of business particularly for small businesses which are unlikely to have the in-house knowledge to determine whether a pension provider is offering value. Therefore, any employer duty should be tiered, depending on the employer's size, and should also not be put into place until the forthcoming VFM framework has been finalized.

We trust that the additional feedback in the following pages proves helpful.

Chapter 2 – Achieving scale in the Defined Contribution market

1. Do you think that providers should be restricted to a limited number of default funds, and if not why? Please consider any equality considerations, conditions and to what extent saver choice could be impacted.

2. The proposed approach at default fund level could mean that the number of default arrangements would remain unchanged. Will imposing the requirement at this level have any impacts on the diversity of investments or the pricing offered to employers?

We agree with your analysis that there are hundreds of default arrangements and this results in a complex landscape to navigate through for providers, employers and even individual savers. However, this is in part at least due to the requirement to designate some arrangements as default arrangements due to a lack of clarity in the Occupational Pension Schemes (Charges and Governance) Regulations (SI 2015/879). Such arrangements have become known as “accidental” or “unintended” defaults.

Therefore, until this problem can be solved by amending regulations, the number of “accidental” defaults will almost certainly continue to increase and no meaningful discussion about a limit on the number of default funds can be had.

However, we do agree partially with your assertion that larger default funds could lead to better member outcomes either through greater economies of scale or just being large enough to take advantage of more investment opportunities requiring scale. We would emphasise here though that this does not necessarily mean such investment would be directed into the UK.

In considering the Government’s proposals, we think this scale can be achieved at the level of the actual investments being made, which may be different from what an employer or saver sees at the “front end” of the pension offering. Therefore, we think there needs to be greater clarity as to what is actually being proposed and the terminology being used.

As a result, we would rather phrase our answer in terms of what is intended rather than using specific terminology.

Therefore, we suggest that the most meaningful approach is to address this at the actual level where investment decisions are made, and strategy is implemented. This is because in any investment strategy there may be several different investment funds and therefore limiting the number of these funds that make up the overall strategy could be detrimental.

Exceptions should be made in certain cases such as Shariah funds or funds that are newly set-up (in order not to limit innovation and start-up in the market).

We also ask for clarification about the scope of the proposals. Are "non-commercial" master trusts and schemes serving several employers within a single connected corporate group intended to be in scope?

3. What do you think is the appropriate minimum size of AUM at default fund level within MTs/GPPs for these schemes to achieve better outcomes for members and maximise investment opportunities in productive assets?

As these are very radical proposals, we favour starting at a smaller minimum size level and then over time this can be increased in an organised manner if appropriate. This would reduce the pressure on schemes to dramatically scale up in a short period of time and thereby reduce the chances of "shock" events or unintended consequences.

Therefore, we suggest £10bn as a starting level, noting that this is still a significant level when compared to the current market.

4. Are any other flexibilities or conditions needed regarding the minimum size of AUM (for example, should it be disapplied in circumstances at regulators discretion for example to enable an innovator to provide competitive challenge in the market or be disapplied in case of a market shock or another specified circumstance)?

We agree with examples in the question.

5. Do you think there should be targets for (i) achieving a reduction in default fund numbers down to a single fund and, (ii) setting incremental minimum AUM?

We believe that the timescale for these proposals should be framed along the lines of "five years from when enacting legislation is passed by Parliament" rather than a fixed date of 2030. We have seen previous cases where a calendar deadline has been set but the accompanying legislation has not been enacted until shortly before that deadline and this has resulted in uncertainty and increased costs.

6. Are there any potential barriers/challenges that should be considered in reaching a minimum size of AUM at default fund level before a future date, such as 2030?

Other challenges to be considered are:

- The possibility that a forced transfer from a sub-scale scheme leads to higher pricing for members
- The impact on market movements of large asset transfers happening in a constrained timescale
- The impact of these transfers on the admin capacity of pension providers

There also need to be risk mitigation strategies for geo-political risk which could materially impact on transfers. For example, there could be procedures to delay a transfer if stock markets were to fall suddenly by a specified amount.

7. Given the above examples, what exclusions, if any, from a required minimum size of AUM at default fund level and/or the maximum number of default funds requirement should government consider?

We agree with the examples you have cited and also suggest the following should be considered:

- Funds set up to comply with religious requirements (eg Shariah funds as already mentioned above)
- Funds offering some form of guarantee, eg GARs or With Profits
- Specialist funds already investing in productive finance

8. With regards to the proposals in this chapter, we anticipate the need for mechanisms to encourage innovation and competition, and for safeguards to protect against systemic risk. Are there other key risks that we need to consider? How do we mitigate against them?

We believe that there is a real risk of the current provider market entering a state of limbo whilst these proposals are being discussed and made into legislation – who will now choose a "sub-scale" provider in the next five years if that provider might cease to exist after that time? Anecdotally, we have already heard that these concerns are having an impact on provider selection exercises and that there is a danger of a self-fulfilling prophecy occurring whereby smaller providers cannot gain new business and therefore cannot scale-up in order to meet the government's targets in time.

9. Under a minimum AUM model, competition in the market could be more restricted. Would additional exceptions be required to ensure innovation can continue to flourish?

Please see our answer to Q7.

10. We would welcome views on what further interventions or regulatory changes might be necessary or beneficial to accelerate this process?

We do not believe that there is a requirement to accelerate this process further. Consolidation is already happening through "natural" market dynamics and attempting to "force" this could lead to unexpected consequences and distortions in that market.

However, it would be helpful to revisit the Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations SI 2006/349 to provide greater clarity and easements about when consultation is required when moving from a single-employer trust to a Master Trust or changing Master Trust or GPP provider.

11. How would moving to a single price for the same default impact positively or negatively on employers, members and providers?

It is important to be clear how pricing of pension products is constituted. In general, pricing will take into account both administration costs and investment fees. The structure of investment fees is likely to be largely fixed for a particular fund but administration costs can vary depending on factors such as the size of an employer's workforce with the average administration cost tending to decrease as the number of employees goes up. This means that larger employers are often able to use their "buying power" to negotiate better terms on behalf of their employees. With administration and investment charges being separately disclosed under the proposed value for money framework this should (correctly) lead to homogenous pricing within investment fund at member level, even if differential admin member pricing is allowed.

It therefore follows that if single pricing is applied uniformly across the same default for investment and administration charges this will in theory lead to cross-subsidisation between different employers' workforces with savers from smaller employers likely to benefit from this and savers from larger employers likely to incur higher charges.

Chapter 3 – Contractual override without consent for contract-based arrangements

For clarity, we ask for confirmation whether these proposals will also apply to Stakeholder pension schemes – many of which are old-fashioned "legacy" pension schemes which are unlikely to offer good value compared to more modern pension schemes. We have seen the reference in footnote 1 but it will be helpful if you can explicitly confirm that Stakeholder pension schemes are included.

12. Under what circumstances should providers be able to transfer savers to a new arrangement without their consent?

We agree with you that the key situations are where

- an arrangement has been rated "red" under the proposed VFM framework;
- transferring to a new arrangement will improve value more readily than attempting to improve the existing arrangement; and
- savers are in "legacy" arrangements and would be better served by moving to a more modern arrangement.

13. Do you think that an independent expert, such as an IGC, should be responsible for undertaking the assessment of whether a transfer is appropriate?

Whilst, according to the FCA rules an IGC is meant to act independently of the provider, the reality is that IGC fees are normally paid for by that provider and the degree of independence can vary between IGCs. Therefore, there is always a risk of indirect pressure, at the least, being put on the Chair of the IGC by the provider.
Having said that, this is less likely to cause any conflicts where a transfer without consent will result in savers' funds moving to a better value arrangement within the same provider's offerings.

We think where a poor value arrangement is identified that it is unlikely that a provider will not be able to offer a better value arrangement at all within its offerings and therefore the possible conflict of an IGC having to recommend a transfer to a different provider is unlikely to occur.

In light of these considerations, we are content that an IGC should undertake these assessments. However, we would expect IGCs to use the services of EBCs and/ or other advisers to assist with these assessments and these should be regulated as set out in our response to Chapter 4.

14. What, if any, changes may be needed to the way an IGC's role, or their responsibilities/powers for them to assess and approve contractual overrides and bulk transfers?

Whilst we think it is unlikely that an IGC will ever be placed in a position where it recommends a bulk transfer to a destination outside of the incumbent provider, we believe that IGC duties should be amended to make clear that, should this situation arise, they must make such a recommendation where it is in the best interests of savers.

One option would be to provide a statutory discharge of liability to IGCs where they have acted in accordance with independent advice. Another option may be to look at the parallels with the transfer of books of insurance policies where a Court approves the transfer (Part VII transfer under FSMA) with input via an independent expert's report – but it may be too tight time-wise to add much in on this and it is an expensive process.

15. What, if any, role should the employer have in the transfer process?

We agree that employers (that still exist) with active savers in the arrangement should be consulted and their views taken into account. However, the ultimate decision about the transfer should remain with the IGC. The IGC should be acting in the best interests of the savers and if, for whatever reason, the employer strongly disagrees with the IGC then the employer can change their future pension arrangements for their current employees.

16. For active schemes, would a transfer require a new contract between the employer and provider?

This is likely to depend on the facts of each case. Some existing contracts give the provider scope to change arrangements, particularly where the transfer is to remain with the same provider. But in other cases where contracts have less flexibility or a transfer is to happen to a new provider (albeit we believe this will only happen rarely), then a new contract will be required.

17. What procedural safeguards would be needed to ensure that a new pension arrangement is suitable and in the best interests of members? What other parties should be involved and/or responsible for deciding the new arrangement?

Several points from our earlier answers are relevant here but we would also add that there should be clear requirements set out for communications with members, including timetables for sufficient advance notification.

18. Do you foresee any issues with regards to transferring savers from contract-based arrangements to either other contract-based arrangements or trust-based arrangements? If so, what issues?

Providers may be concerned about challenges from members following a transfer without consent – particularly should it transpire that investment growth in the receiving arrangement was not as expected. The regulations covering the transfer process will need to offer sufficient reassurance to providers that such challenges are rare.
On a practical matter, if investment in illiquid assets does substantially increase then that may result in the need for staged disinvestments over a relatively lengthy period, although where the transfer is happening within the same provider this is less likely to be an issue. We also note that similar issues may arise if an arrangement has significant investments in property.

19. What safeguards and measures should be put in place to ensure that consumers are protected?

It should be made very clear that the overriding duty of IGCs in these situations is to act in the best interests of the members. Further, in addition to avoid situations where members only benefit from marginal improvements, transfers should only be permitted to "green" rated arrangements under the VFM framework (noting that already under the FCA's VFM framework proposals, amber or red arrangements cannot accept business from new employers in any event).

20. Are there any specific circumstances in which a transfer should not be allowed to take place, or savers should be able to opt out?

We start by noting that in the analogous situation of bulk transfers without consent from trust-based schemes there is no right to opt out for members (see Reg 12(1A) of the Preservation regulations (SI 1991/167), although DWP guidance does suggest that members should be able to opt for a different destination fund.

So we are not in favour of savers being given a general opt-out from a bulk transfer, especially where the transferring arrangement has been independently verified as not giving good VFM.

However, we do believe there is a case for savers to opt-out and remain in the original arrangement if the saver is in a specific investment strategy, such as one targeting annuity purchase or the saver is in the pre-retirement switching phase of a lifestyling strategy. Given the point below, in some cases opt out might be more consistent with the policy objective if required to be by way of taking a CETV to a SIPP or other arrangement of the Member's choice.

21. What complications could arise if savers have the choice to opt-out of a transfer and remain in their current arrangement?

If a "rump" of savers are able to choose to remain in their current arrangement then that will defeat many of the objectives of enabling consolidation, namely, increasingly expensive administration of legacy schemes and "residual" investments left in a variety of funds.

22. In what circumstances do you think that consumers/savers should have the right to compensation or an individual right of recourse enforceable in court?

In order to allay the concerns we raised in our answer to Q.18, savers should only have the right to compensation or recourse in very limited circumstances such as clear maladministration or a failure by a provider or IGC to follow prescribed procedures.

23. What safeguards from trust-based bulk transfers may be appropriate for contractual overrides, so that similar consumer protections apply?

We believe that this question is asking what "lessons can be learnt" from the process for trust-based bulk transfers without consent and what could be applied in the contract-based space. We have considered this aspect in our answers to the other questions in this chapter.

24. Where the transfer is into a trust should the duties of the receiving scheme trustees be extended to ensure terms and conditions balance both the interests of incoming and current members?

This should not be necessary since the existing fiduciary duties of the receiving trustees to their current members should mean they would not accept a transfer that is likely to be detrimental to their current membership.

25. How should the cost of the transfer be borne?

Ultimately, for commercial pension products, all costs are borne by savers (and possibly employers if they subsidise costs).

However, savers should not be charged any explicit cost for a bulk transfer, even where it is believed that this will lead to better outcomes. We understand that providers are also likely to benefit from consolidation resulting from bulk transfers due to factors such as no longer having to maintain legacy IT systems and having fewer arrangements to manage.

26. What costs do you expect to be involved in a contractual override/bulk transfer and what factors may influence the level of costs?

The additional duties and responsibilities placed on the IGC to carry out the assessment, either directly or with the assistance of external advisers, will incur costs.

Depending on how the actual transfer of assets is carried out, there may also be transaction costs to be met.

27. What benefits may a member lose out on because of a bulk transfer? What benefits could they gain?

Members may lose out on valuable benefits such as With Profit or other guarantees as well as pensions tax protections which may be lost on a bulk transfer if these are not taken into account during the assessment and transfer process.

Members may also lose out on the intangible benefit of brand familiarity if their transfer results in their pension being administered by a different named provider (even if that would likely still be in the same corporate group).

If the assessment of the bulk transfer is done properly then members should gain better value from that transfer.

28. What role should the FCA, and where appropriate TPR, have in contractual overrides and the bulk transfer process?

There would be merit in investigating whether FCA and / or TPR should have the authority to empower providers to make bulk transfers in savers' interests where such transfers are otherwise blocked. However, this could be a significant enhancement of regulatory powers and therefore it must be considered carefully and only enacted with appropriate safeguards.

Chapter 4 – Costs versus Value: The role of employers and advisers

29. Do you think establishing a named executive with responsibility for retirement outcomes of staff could shift from the focus on cost and improve the quality of employer decision-making on pensions?

Our overriding comment in this chapter is that there is a tension between protecting employees and not adding excessive compliance costs to businesses – particularly small businesses – in doing so. Therefore we believe that any decision about this should not be finalised until the forthcoming VFM framework has been put into place.

However, we do believe that these proposals could shift the focus away from cost. But, the impact will depend on the size of the employer and we believe great care needs to be taken when deciding whether it is appropriate to put this type of duty on smaller employers, in light of the forthcoming proposed value for money framework.

Many larger employers already have a focus on pension provision at a senior level (because it is one of the most valued and costly benefit companies provide), so the impact of having a named executive with these employers will be limited. Larger employers also tend to use external advisers, so they will be expected to consider value as part of any recommendation.

At the other end of the scale, owners of small managed businesses will already be involved in the selection process anyway. However, in these cases decisions are more likely to be based on simply complying with their auto enrolment duties, ease of administration and pricing rather than value. This is because of a general lack of detailed pension knowledge amongst smaller and medium-sized business owners and the fact that they are focused on simply running their businesses.

It is probably in larger medium sized companies that having a named executive is likely to have the most impact on the most employees but our view is that the forthcoming VFM framework should be used to ensure minimum standards such that small and medium-sized employers can rely on that to ensure they are compliant. And therefore we state again that these proposals should not be finalised until the forthcoming VFM framework has itself been finalised and clarified.

30. What evidence is there that placing a duty on employers to consider value would result in better member outcomes? If such a duty was introduced, what form should it take? Should it apply to a certain size of employer only? How can we ensure it is easier for employers to make value for money comparisons?

All employers should have a focus on value, but the resources available to different employers must be recognised. Currently, it is mainly larger employers, led by their advisers who are considering value more in their selection exercises. Having an obligation to review value at regular intervals (in conjunction with the VFM requirements) will help to create better outcomes.

Any duty should consider the size of the employer and the resources they have available and the requirements should be tiered, based on the size of the employer. For example, smaller employers could have a requirement to look at the VFM scores for their scheme and take a view as to whether the scheme is providing value (although arguably this in unnecessary as there is a duty is on the provider who is sanctioned under the value for money framework for not achieving the green RAG rating) whereas larger employers are more likely to undertake a more in-depth review, including obtaining feedback from active members on areas such as service, performance etc. and obtain professional advice. To make it easier for employers to make VFM comparisons, a framework/set of guidelines (based on the size of the employer) issued by TPR/FCA would be helpful.

The guidelines could cover, for example, the benefits of having a governance committee, how to select an adviser, making it clear to procurement teams that selecting a pension scheme cannot be based on cost, but value.

This would allow employers to easily understand what their duty is without it becoming a huge burden. We believe that any framework should not be overly prescriptive and as part of that, a review should be undertaken at least every 5 years or when there is a material event (at the provider or employer) that could impact (e.g. merger, sale, acquisition).

As a pragmatic way forward, we suggest that if an employer duty is introduced then the threshold level is set at 50 employees – the same as that at which the Employer Consultation regulations (Si 2006/349) currently apply from.

31. What evidence is there that regulating the advice that some employers receive on pension selection will better enable them to consider overall value when selecting a scheme?

Currently regulated firms that give advice usually have the scale and expertise to be able to consider the whole market and what the key elements that lead to good outcomes are. They also normally have strong knowledge of the whole market (rather than a small

number of providers). All these factors lead to the conclusion that regulating advice will lead to better overall value.

A clear definition of what advice to employers is considered regulated and what the advice needs to be cover would be advantageous – this should take into account all aspects of advice that the employer needs (at outset and on an on-going basis).

32. What evidence is there that regulating the advice that pension schemes receive on investment strategies would enable more productive asset allocation? What type of regulation would be effective?

Regulating advice will not necessarily enable more productive asset allocation, as the advisor would need to consider whether this is the right investment taking into account all factors and how to deliver the best outcomes for savers.

However, we do believe that regulating advice would be a positive development. Currently regulated advisers tend to have wider experience of different asset classes and a bigger research function. This knowledge, by definition, means that the advice received is more in-depth and opens up the possibility of investments in wider asset classes. Many firms already consider this type of work as a regulated activity and follow the FCA rules. It would therefore be appropriate to use this and the regulations that came into force as a result of the CMA review on the oversight of investment consultants and fiduciary managers. as the starting point for any regulation. Individuals and/or firms who provide advice to employers could also be required to undertake additional training and obtain certification authorising them to provide employers with this type of advice.

Chapter 5 – Impacts and Evidence

We believe other respondents will have better data to answer the questions in this chapter and therefore we have opted not to respond to these.

We hope our comments are useful in helping move the discussion about these proposals forward. We would be very happy to discuss any of our views further with you.

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