Smart Pension

DWP review of the default fund charge cap and standardised cost disclosure: response from Smart

Executive summary

- **This is an important call for evidence and we welcome the DWP looking at this issue in a careful and constructive way.** The issue of pensions costs and charges has previously been a hot topic, but great strides have been made in recent years to reduce costs and improve transparency, both of which are clearly welcome.
- **While we understand the DWP's concern around transaction costs, we do not agree with proposals to bring these costs under the current charge cap.** This is due to the risk of creating perverse incentives for providers/schemes and fettering them acting in members' interests. However, if the DWP is minded to cap transaction costs then it should do so separately, via a soft cap to be used as a trigger point to require additional reporting on transaction costs by the provider/scheme. Such a 'comply or explain' regime would not fetter providers' or schemes' ability to do the right thing by their members, but it increases transparency and accountability and is a sensible middle ground when it comes to managing these costs.
- **The charge cap has achieved its objective in removing the worst excesses of fee charging and should not be lowered at this stage**, although the Government should keep under regular review. The Government needs to take into account that pots created by auto enrolment are still small and the economics of operating in the auto

enrolment space, with miniscule margins, are stretching, particularly during the current period of economic uncertainty. This coupled with an explosion of small deferred pots means that the Government needs to tread very carefully before making any changes to the charge cap level or structure.

- **It is understandable that the Government has raised concerns about small fees eroding the value of people's pension savings.** This issue was particularly prevalent in the early days of auto enrolment for deferred members given contribution rates were so low, so quite correctly they initially received bad press. However, it should be stressed that there are pros and cons of different charging structures and there is no one-size fits all approach that will deliver a perfect outcome in all scenarios. Indeed flat fees can be of considerable advantage to a saver as their pot grows to moderate levels . They also reflect how underlying costs are incurred and therefore remove excessive cross subsidies and excess revenue/margins when compared with an AMC-only charging basis when pots do reach a certain size. PPI research[1] demonstrates the impact of different charging structures on outcomes for members and shows that flat fees can equally deliver good, if not the best, outcomes for members with a prolonged period of savings and consolidated pensions. The DWP's concern around smaller deferred pots is valid, but this reflects a more important issue regarding dealing with the small pots problems as opposed to restructuring charging types further.
- **From a principled perspective, we struggle with the proposal to introduce a de minimis as set out in the call for evidence** as we think the approach should be on

[1] https://www.pensionspolicyinstitute.org.uk/media/3263/20190911-pension-charging-structures-and-beyond.pdf

tackling the root clause of the issue (i.e. small pots). However, if the DWP is minded to introduce a de minimis then it should link any thresholds (in so far as it can) to a realistic assessment of the costs of running a pension scheme and ensure any approach doesn't add complexity. We also think that any de minimis should only apply to deferred members. No provider should be forced to run pots or a section of its membership at a loss through regulatory intervention. In our view, it would be extraordinary for the Government to regulate that providers do not have the ability to recover their costs and could ultimately be seen as anti-competitive given NEST's position.

- However, we do understand the public perception concerns about small pots being depleted to zero. Therefore we think a de minimis which ensures pots cannot be depleted may be a sensible interim measure until the wider small pots problem is resolved. A de minimis of £100 which flat rate admin fees can't be collected on deferred (or non contributing) members could be justified as a fair way forward, and balances providers' financial considerations with the right incentives for members to consolidate pots, while removing the risk of these pots being depleted to zero. If this is imposed, the DWP/TPR should also not collect its flat rate regulatory fees and levies on pots below the de minimis.

- **The DWP's own analysis shows the expected proliferation of small pots.** This is a problem that needs addressing, not only for reasons associated with charges, but also to ensure members don't lose track of their pensions and to ensure efficiency in pensions administration. To this end we support proposals to look in more detail at the small pots solution with a view to coming up with solutions. As is set out in the Work and

Pensions Select Committee recent letter to providers, we need resolution on this issue. Furthermore, we think this needs to be looked at ahead in parallel with or before any changes to the charge cap rules.

- Cost transparency through the use of CTI templates is to be welcomed and at Smart we have adopted the templates. **The Government should pursue voluntary adoption, but reserve the right to mandate use if take up is patchy or too slow.**

Questions

Including transaction costs within the charge cap

Q1. What are the advantages or disadvantages of extending the cover of the charge cap to include some or all transaction costs?

1.1. We appreciate and fully understand the concerns that have been set out regarding transaction costs, particularly that they could be artificially inflated, although we agree that transaction costs are generally quite low for listed, broad market assets and we don't see any advantage in extending the charge cap to cover transaction costs, particularly as this would mean curtailing the opportunity set of investment that schemes could invest in. However, this view is predicated on delivering transparency.

1.2. Transaction costs are a cost of doing business for pension schemes and investors. They are unavoidable. We believe that transparency and reporting of these costs and charges is important, both to give scheme governance the information it needs to do its job effectively, but also for wider public trust and confidence (although we note here that disclosure of transaction costs to savers is of limited value due to their complexity).

1.3. However, to fetter a scheme's governance and decision-making by including transaction costs in the charge cap seems excessive and unnecessary, as strong governance should be monitoring and challenging such costs as a constituent part of the value for money assessment. Furthermore, calculating transaction costs is not a straightforward exercise, as the DWP itself notes, and inclusion within a charge cap could distort behaviour and fetter scheme's and provider's investment approaches. We believe it is far better to place the onus on trustees and IGCs to ensure any costs are necessary, proportionate and achieve value for money.

1.4. If the DWP was minded to act in this area then we would advocate that the Government consider introducing a 'soft cap' or trigger point for providing additional

explanation of transaction costs as part of scheme governance reporting. This would work on a 'comply or explain' basis by setting a level of transaction costs above which providers and/or schemes need to set out the reasons for higher than normal transaction costs. This would not fetter decision-making, but could enhance transparency and force scheme governance to focus on and explain outliers.

Q2. What would be the impact on scheme member returns/industry if some or all transaction costs were covered by the cap?

2.1. If there was evidence of member detriment due to artificially high or excessive transaction costs then the impact of a transaction cost cap would be positive for members.

2.2. From a provider's perspective, including transaction costs in the cap would limit the types of asset class we would be looking to invest in. As we look to more sophisticated and alternative asset classes, and move away from passive trackers, to deliver better outcomes for members then these types of investments may have different or increased transaction costs. However, as long as these are properly considered and scrutinised by scheme governance, and that assessment comes out as net positive for the member, then schemes should be free to innovate in investment approaches.

2.3. We also note that the Government wants schemes to innovate from an investment perspective, including investing in alternative asset classes and improving ESG credentials. All these initiatives come with a cost and intervention could have unintended consequences.

Q3. Should there be a combined transaction cost and charge cap, or should these be separate?

3.1. We don't believe that there should be a cap on transaction costs.

3.2. However, if the DWP does decide to introduce one then it should be separate, with an ability for scheme governance to either comply or explain adherence to the cap as per our suggestion in response to question one. This will allow flexibility for scheme governance to do its job effectively, but reinforces transparency through trustees and/or IGCs having to explain why any cap is breached.

Q4. Who should be responsible for complying with a transaction cost cap?

4.1. This has to be the ultimate responsibility for scheme governance ie trustees or IGCs, although prediction of future costs is inherently very difficult so ideally there would be

some requirement placed on asset managers. This is why we would advocate a comply or explain regime if the DWP is minded to cap transaction costs.

The level of the charge cap

Q5. If we lowered the cap, what would be the impact on (a) scheme member outcomes (b) industry?

5.1. The charge cap is doing its job and doing it effectively, and while the DWP is right to review both the level and the structure of the cap, we believe that there is not a solid nor rational case for a change in the overall level at this time. In our view the charge cap should be there to act as a backstop, to ensure that auto enrolment savers are protected from some of the charging excesses (of some providers) of the past. We note here that the auto enrolment workplace market is highly competitive, with many workplace schemes (particularly for larger employers or employers with eg higher contributions) being priced well below the charge cap. In our view, this dynamic is certainly having an impact on the amount the schemes can allocate to more sophisticated investment approaches.

5.2. The DWP should also remember that auto enrolment is still in its infancy and pot sizes are still relatively small: to illustrate, we have over 150,000 pots below £100, over 80,000 pots between £101-£200 and over 50,000 small pots between £201-£300 (the majority of these being deferred pots). It is well documented that the economics of running an auto enrolment scheme are challenging, with wafer-thin margins, and significant employment churn adding considerably to cost. While it is arguable that 75bps could be seen as expensive for a large pot, for a small pot it represents incredible value, and until pot sizes grow many mass market providers (ie the ones that don’t cherry pick), will be making a significant loss on a large part of their book. This is why we think that the DWP should let the market mature before it considers lowering or changing the cap. In addition, in our view, it is important that the market remains competitive and that barriers are not created (either through charging cap levels or structures) that make it impossible for new entrants to enter the market - that would be a retrograde step in our view, and could stifle modernisation of, and innovation in, the pensions sector.

5.3. Indicatively, with pricing at 75bps and absent a fixed fee Smart is not breaking even on a significant proportion of our smaller membership, for which we require pots to exceed £1,000. Even at a pot size of £500, charges will only equate to £3.75 which would not be enough to cover costs.

5.4. Finally, lowering the charge cap at a time of significant economic uncertainty and when the Government is encouraging schemes to develop more sophisticated (which equals expensive) investment approaches would be counterproductive in our view. For example, ESG funds are typically more costly, and a lower cap would make a move to ESG harder to justify.

Q6. 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)?

6.1. Where the charge cap has had an impact on investment, it has led to less sophisticated asset allocation and more vanilla/passive investment approaches and a move away from more active strategies.

Q7. Have schemes changed administrator or asset manager in response to the cap?

7.1. We believe so, but others are in a better position to comment.

Q8. What links have you found between cost and performance?

8.1. Performance in investment is more than a one-dimensional concept, but is often boiled down to returns vs cost, without due consideration to the risk taken. This is why we think short term comparisons that focus on three, six and twelve month returns are all but meaningless when it comes to assessing long term potential and performance.

8.2. Cheap or lowest cost isn't always best and we would caution DWP against promoting a race to the bottom. Trustees are already required to undertake a value for money assessment, and the Regulator also recognises that value does not necessarily equate to cheapest. If the Government was to further lower the cap then it needs to accept that the vast majority of members will be in plain passive investment strategies, that will sacrifice risk and return for a reduction in cost.

8.3. There is a clear link between cost and performance, as cost inevitably impacts the opportunity set available. For example, investing in physical real estate entails high costs from a high degree of active management as well as relatively high transaction and maintenance costs. In exchange, physical real estate provides a diversified, inflation-linked return stream, for which there are few comparable alternatives amongst the low-cost, passively managed opportunity set.

8.4. Many fixate on and try to interrogate the relationship between the magnitude of returns versus the magnitude of costs. However, in doing so, the types of returns available at different cost levels are overlooked. Non-mainstream asset classes (e.g. alternative assets, unlisted assets, trading strategies, derivatives, etc.) often provide return streams that exhibit low correlation to equity markets, provide exposure to emerging return drivers not yet available in broad markets and even provide return linkages to different economic variables (such as inflation, commodity prices, etc.).

8.5. In light of the developments over 2020, these types of return streams and sources are likely to be increasingly valuable in rebuilding the global economy. Moreover, they are

unlikely to be found sufficiently within broad markets. A narrow focus on low costs will inevitably restrict the types of return sources to those only accessible at low cost points and hence, restricts the possible outcomes for members as well. Gone are the chances for meaningful diversification, investment in brown/greenfield, sophisticated risk management, amongst other benefits that come at higher costs.

8.6. Even those with enough purchasing power to access conventionally 'expensive' asset classes within the existing charge cap, have to contend with only small allocations — effectively restricting the available benefits of those assets.

Q9. How much notice should be given for any reduction in the cap?

9.1. As we note previously we do not think that the charge cap should be reduced. However, if the government is minded to make changes either to the level or requirements of the cap, then we think notice of at least two years should be considered.

9.2. This is particularly important for auto enrolment master trusts as changes could significantly affect business plans that have to be submitted and scrutinised by the Pensions Regulator as part of the master trust supervisory regime. It also allows auto enrolment to further bed down as the economics of running schemes is stretched and the Government needs to give time to allow providers to adjust.

9.3. Providers would also need a lead time to make any system and administrative changes to reflect any change, and to communicate effectively with members, employers and advisers.

Use of combination charges

Q10. 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?

Q11. 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?

Q12. 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?

Q13. What would be the impact on scheme members/ industry?

13.1. Flat fees have received a bad press in recent times, most notably in the early days of auto enrolment when the combination of frequent job moves and small levels of contributions made such charging structures less suitable. We understand why the DWP is looking carefully at the issue, but we think it is less about charging structures and more of an issue about the proliferation of small pots caused by auto enrolment.

13.2. With this in mind, we do not support the introduction of a statutory de minimis in line with the illustrative example in the call for evidence and think that the issue of small deferred pots should be tackled first.

13.3. Small pots are bad news for the pensions industry, but, more importantly, they are bad news for the saver. Small, fragmented pots, get lost and do not provide a solid platform for engagement. While pensions dashboards will help people keep connected with their pots, and perhaps proactively consolidate these in some cases, further intervention is needed to address the issue and stop the problem growing. We would urge the DWP to consider implementing solutions to the small pot problem as a matter of priority.

13.4. We have looked at various options to address the small pots issue and are working with other providers (and the PLSA) to explore workable solutions that may or may not require government intervention. While pensions dashboards will help, we don't

think they will ‘move the dial’ sufficiently to address the problem. We think the following options all have merit and deserve serious consideration:

13.4.1. **Member exchange**: This would allow schemes/providers to consolidate small pots of deferred members to a scheme that the individual is actively saving in, and would involve a ‘coordination hub’ to do the matching and help manage the process, including assessing whether a transfer is in a member’s interests. It would be up to the ceding scheme what members they included in the system and trustees could use the bulk transfer without consent regulations to facilitate the transfer, and members could always opt out if they wanted to. This could provide a good route for dealing with the issue of proactively consolidating small pots, although given uncertainty concerning volumes, we are concerned that it will take a long time to have a material impact. We think this option coupled with limited legislative support (see below) could make a significant dent in the problem.

13.4.2. **Member exchange (with limited legislative support)**: this option is as above, but with the government relaxing conditions within the bulk transfer without consent regulations to remove or reduce the duties of trustees to consider whether a transfer is in a members best interests for very small pots). The added advantage of this option is that it tackles head on the consolidation of micro and very small pots, where the advantages of consolidation far outweigh individual financial considerations that could amount to a matter of pence. Introducing such an easement for very small pots will really kick start the member exchange process and, in our view, make a significant difference in tackling small pots.

13.4.3. **Micro pot refunds**: one really common reason for the creation of small deferred pots is people wanting to opt out just outside their opt out window. For example, we have over 35,000 members who have ceased making contributions within the month after the opt out window ending. Many of these would have just missed the opt out window. This not only creates a small pot, it is a poor customer experience as providers are not in a position to refund the contributions. A simple easement that would help prevent small pots being created in the first place might be to allow a refund for very small (or micro) pots. Alternatively the Government could extend the opt out window from a month, to say, two or three months to help deal with this issue. Although this wouldn’t deal with current small deferred pots, it helps prevent the issue arising again in the future by stemming the flow of small pots, so is well worth looking at alongside the member exchange option outlined above.

13.5. However, if the DWP were minded to introduce a de minimis for smaller pots with flat fee charging structures then the level needs careful consideration, and it should not force providers to be in a position where they are making a loss on certain portions of their book. As noted above, it is important that providers can recoup costs, most of which are unavoidable, otherwise there are unfair and disproportionate cross subsidies within the system and it could potentially have a significant impact on providers’ business models, affecting the financial stability of the wider system. This is particularly relevant in the current economic times given the impact of Covid-19.

Looking at the DWP's illustrative example for setting a de minimis for flat fees, pots below £100 could only charge £5, which is significantly below what it costs to manage a pot. For example, we know from our platform business market rates for administration /technology are in excess of £5 per annum per member for even the largest schemes. In our view, it would be extraordinary for the government to regulate so that providers don't have the ability to cover their costs.

13.6. We also note that the Government currently charges a per member levy on schemes to cover the costs of regulation and other related activity. This is set at a fixed fee and does not take into account the impact of smaller pots and imposes a significant cost burden. We understand that the Government is reviewing the structure and level of the levy and we look forward to feeding into that work.

13.7. We would encourage DWP to engage with providers to understand the economics of auto enrolment schemes to inform any setting of a de minimis. Furthermore we would argue that administrative simplicity should be a key consideration in the introduction of any de minimis to minimise system changes and aid in communication.

13.8. **On balance if the DWP is going to introduce a de minimis then we think it should be at a flat £100 below which admin fees cannot be charged for deferred members.** In our view this gets the balance right between avoiding depletion of pots, creating the right incentives for individuals to consolidate their pots (which is manifestly in their interests) and not crippling providers with loss-making business. Over 50% of the Smart scheme would not make a contribution absent a fixed fee mechanism and over 40% of the portfolio has a pot below £500, with c25% having a pot below £100. In order to set a pricing structure that works for the scheme and is not overly redistributive or uncompetitive it is important that providers are able to charge reasonable admin fees for providing services to a significant proportion of these members, whilst protecting those with the smallest balances and who are not actively contributing from erosion below £100.

13.9. **Any approach should only apply to deferred members.** If a member is actively contributing then their pot size will build up and, by definition, their pots will not be eroding so intervention is not justified.

13.10. An additional point that the DWP should take into account is that the introduction of a flat admin fee approach is, in effect, trading short term revenue for long term revenue. At bigger pot sizes an AMC approach arguably takes excess revenue (the jam today vs jam tomorrow argument) and this should be considered in any future review of the charge cap. As the independent PPI note *"Combination charges (where an AMC is combined with either a flat fee or a contribution fee) generally provide better outcomes over time than an AMC-only approach."* reflecting this short term / long term tradeoff in the impact of charging structures.

13.11. We note that NEST uses a combination charge, and while this type of charge doesn't deplete member pots, it does have a significant impact on members' contributions, particularly when the impact of compounding on future investment returns is taken into account. The introduction of the NEST combination charge (which could be

considered a 'tax' on saving) was in specific response to the significant economic challenge of running a mass market auto enrolment scheme, along with a significant state aid in return for having a public service obligation. For any scheme or provider (state or private sector) it is important that the provider can recover its costs in a fair and proportionate way otherwise that calls into question the long run sustainability of the scheme.

Standardised cost disclosure templates

Q14. Is legislative intervention required to support the uptake of the CTI templates?

14.1. Potentially.

14.2. It depends on the incidence of takeup, but it is probably too early to act from a legislative perspective.

Q15. How easy is it to request cost information from asset managers?

15.1. Historically, many asset managers haven't been geared up to calculate or share this type of information. However, recent initiatives to improve transparency, and the greater regulatory and wider scrutiny on transaction costs, has forced asset managers to respond and provide better data. While this is still work in progress, great strides have been made recently to improve cost information.

Q16. 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?

16.1. Yes, in the interests of transparency this should be made available, although it is hard to see this in reality unless reporting using the CTI is mandatory.

16.2. Furthermore, we would question why this is just limited to recognised unions and members and would suggest that all providers/schemes publish this information as a matter of course as part of normal scheme governance reporting?

Q17. Should DB schemes be required to adhere to the same standards?

17.1. Yes. Transparency aids effective scheme governance and there is absolutely no reason why DB and DC should be treated differently in this regard.

Q18. What are the barriers to using the information obtained when making decisions?

18.1. Using the information is relatively straightforward. The issue is more one of availability of investment product that can meet the objectives of the scheme at a price point that works, when moving beyond simple passive strategies.

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