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Response to: Department for Work and Pensions Review of Automatic Enrolment: Default Fund Charge Cap

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Summary

- The Government should reduce the cap on annual charges for default auto-enrolment pension schemes to 0.5%, or lower, of a member's funds under management, including transaction costs. The cost of providing workplace pensions has fallen significantly since the introduction of current 0.75% cap – especially as a result of increasingly competitive low cost passive asset management – but such reductions have only been partly passed on to auto-enrolment schemes. This is because of weak competitive pressure on providers.

- Most workplace pension schemes that qualify for auto-enrolment have charges within the current annual 0.75% charge cap. However, the total charges on many schemes are much higher than the cap once transaction costs are included. This contrasts to competitive pension products that are directly available to consumers or advisers. Such products have all-in charges, including transactions costs, of less than half the level of the current auto-enrolment cap.

- Overall, this means that members of auto-enrolment schemes are losing large amounts of future retirement income. The Government should therefore reduce the current cap to the level of competitive pension products and continue to benchmark the charge cap in future.

Background

Which? welcomes the opportunity to contribute to the Department for Work and Pension's (DWP) review of the policy of automatic enrolment pensions. Since 2012, auto-enrolment has placed a legal requirement on employers to enrol their workers into a regulated workplace pension, with a phased implementation that began with large employers. Employers are also required to make pension contributions alongside their workers. Which? agrees that the policy has been successful in engaging workers to newly save, or save more, into a workplace pension.

Earlier this year Which? responded to the DWP's consultation on the initial questions for its review of automatic enrolment pensions. This response set out broadly what issues and analysis the DWP's review should cover across the areas of coverage, engagement, contributions levels, and costs and charges. Each of these issues is crucially important for delivering good outcomes for consumers.

In particular, Which? is concerned about the charge cap for default auto-enrolment schemes. Since introduction in 2015, the charge cap has limited the annual level of charges for members that have not opted out of the default investment fund designated by their employer's pension provider. Following consultation by the DWP on a range of options, the Government set the annual cap at 0.75% of a member's funds under management or an equivalent combination charge.[1]

High pension charges are one of the largest sources of detriment to UK consumers, substantially eroding the value of future retirement income. The Office of Fair Trading's (OFT) 2013 market study identified £30 billion of savers' money in workplace pension schemes with charges at risk of being poor value for money.[2] Moreover, the FCA recently found that the wider £3 trillion UK pensions market is characterised by "little evidence that firms compete on the basis of price" and "no clear link between price and performance".[3]

The OFT concluded that competition alone cannot be relied upon to drive value for money in workplace pensions, as the buyer side of the market is weak. Namely, while members contribute towards a workplace pension and bear the cost of the provision of the scheme, it is their employer that chooses the pension scheme.

The auto-enrolment charge cap is therefore a crucially important safeguard for consumers. Which? welcomed the introduction of the charge cap but called for the level and scope of the charge cap to be kept under review. This submission sets out our assessment of what should now happen to the charge cap, based on the available evidence of how charges in the wider pensions and savings market have developed.

Pension providers should invest default auto-enrolment pensions primarily in low cost passive funds

Since the charge cap was introduced in April 2015, the DWP has published a survey of defined contribution workplace pension schemes that provides evidence on the level of charges up until the cap was introduced. The survey found that almost all members of pension schemes that qualified for auto-enrolment were already paying annual charges, excluding transaction costs, within the cap and that average charges excluding transaction costs were considerably lower, namely:

- all members of qualifying master trusts, 88% members of other qualifying trust-based schemes[4] and 76% of members of qualifying contract-based schemes[5] paid charges within the cap before it was introduced; and

[1] Upfront charges or flat fees, in combination with a charge based on funds under management.
[2] Office of Fair Trading (2013), *Defined contribution workplace pension market study*, p.116
[3] FCA (2017), *Asset Management Market Study Final Report*, para. 6.2.
[4] Trust-based pension schemes are sponsored by the employer but managed by a board of trustees.

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- average charges for members in qualifying schemes were 0.46% for master trusts, 0.42% for other trust-based schemes, and 0.5% for contract-based schemes.[6]

This followed a long downward trend in charges for workplace pension schemes, following a series of critical reports. The OFT's analysis, for example, showed that for newly established workplace pension schemes the average Annual Management Charge – which is a narrower definition of costs than is used for the charge cap – fell by a third in just over a decade, from 0.79% in 2001 to 0.51% in 2012.[7]

The trend towards lower charges for workplace pension schemes in part reflects a shift in investment approach towards passive investment funds. These funds track the market and are significantly cheaper than funds that are actively managed. Indeed, the FCA has found that average charges for active funds are, on average, six times as high as those for passive funds.[8] The FCA has also estimated that, on average, defined contribution pension schemes now invest just 30% in active management with the rest in passive management.[9] Indeed, default auto-enrolment funds should be almost entirely composed of such passively managed funds.[10] Both the theoretical[11] and empirical evidence[12] show that, on average, active funds do not outperform passive funds but charge significantly more. Encouragingly many auto-enrolment pension schemes predominantly invest in passive funds: NEST, for example, makes clear in its investments principles that it strongly prefers indexed (i.e. passive) management, where available.[13]

Furthermore, recent competitive pressures have driven down the cost of passive investment funds considerably. Since the DWP set the level of the cap, the FCA's asset management review has found that for passive UK equity funds the average Ongoing Charges Figure fell by more than a third between 2012 and 2015, from 0.24% to 0.15%; whereas charges for actively-managed funds remained unchanged during the same period, at 0.9%.[14] The Ongoing Charges Figure is a similar measure of charges to that used for the auto-enrolment charge cap, covering a number of costs in addition to the Annual Management Charge.

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[5] Members of contract-based pension schemes sign a contract with a pensions provider appointed by their employer to run the scheme.
[6] Department for Work and Pensions (2015), *Pension Charges Survey 2015: Charges in defined contribution pension schemes*, p.19.
[7] Office of Fair Trading (2013), *Defined contribution workplace pension market study*, pp.99-100.
[8] FCA (2016), *Asset Management Market Study – Interim Report, pp.10-13.*
[9] Financial Conduct Authority (2016), *Transaction cost disclosure in workplace pensions*, CP16/30**, p.31.
[10] Active management is not in itself necessarily worse than passive management: the problem is that consumers should not be paying any significant amount more for active management than passive management.
[11] For example, William F. Sharpe has argued: "If 'active' and 'passive' management styles are defined in sensible ways, it must be the case that: 1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar; and 2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar. These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required." Sharpe, William F., "The Arithmetic of Active Management", *The Financial Analysts' Journal,* Vol. 47, No. 1, January/February 1991. pp.7-9.
[12] FCA (2017) found that "active funds, on average, […] underperformed benchmarks after charges", para. 6.3.
[13] "Indexed management, where available, is often more efficient than active management." NEST (2015), *Statement of Investment Principles: April 2015 to March 2018*, p.9.
[14] FCA (2016), *Asset Management Market Study – Interim Report, pp.10-13.*

The Government should include transaction costs within the charge cap

The current charge cap includes all scheme and investment administration charges but it excludes transaction costs. These costs are defined in regulations as "the costs incurred as a result of the buying, selling, lending or borrowing of investments".[15]

However, it is the total cost paid for by consumers, including transaction costs, that should be of concern to policymakers and regulators, especially considering that:

- transaction costs are ultimately within the control of providers, as transaction costs are a direct function of investment strategy and shopping around for best pricing; and
- transaction costs can more than double the total cost to consumers of a pension.

There is currently little transparency of transaction costs and so there is weak competitive pressure to minimise these costs and that may also be incentives to inflate such costs, for example:

- The OFT raised concerns about the lack of visibility of transaction costs within investment funds, concluding that, as a result, it is unlikely that competition can effectively be brought to bear on them. The OFT also raised concerns regarding the potential for conflicts of interest to emerge in the supply chain such that charges may not always be managed down in the interests of scheme members.[16]
- The DWP's 2015 pension charges survey found that most pension providers were unable to provide an estimate of the transaction costs that their members were paying. Of those that knew, most had low costs but some had costs that could more than double the amount that consumers pay each year for default funds, on top of the charge cap of 0.75%.[17]

Keeping transaction costs low is another reason for pension providers to invest in low cost passive funds, rather than active management, as passive management entails a much lower turnover of funds. For example, the FCA has estimated that the turnover rate of active funds is on average ten times the rate of passively managed funds,[18] and that explicit transaction costs (those which are directly observable) for active funds are 20 times those of passive funds.[19] The FCA has found that transaction costs for active equity funds are around 0.5% of assets under management.[20] This illustrates part of the large inflation of costs resulting from active management and how pension providers can considerably manage down transaction costs through choice of investment strategy.

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[15] *The Occupational Pension Schemes (Charges and Governance) Regulations 2015*, Part 1: Introduction

[16] Office of Fair Trading (2013), *Defined contribution workplace pension market study*, p.18

[17] "Transaction costs were not straightforward for providers to measure, although four providers [of 12] were able to produce broad estimates of these… Two reported that they typically equated to between zero and 0.75 per cent per annum." Department for Work and Pensions (2015), *Pension Charges Survey 2015: Charges in defined contribution pension schemes, p.3 & p.21*

[18] The FCA states that: "Based on our understanding of the market, and typical levels of portfolio turnover previously reported, we assume that an actively managed fund turns over its portfolio roughly once (i.e. 100% turnover) per annum (buys plus sells) and a passively managed portfolio turns its portfolio over roughly 10% per annum (buys plus sells)." Financial Conduct Authority (2016), *Transaction cost disclosure in workplace pensions*, CP16/30**, p.31

[19] The FCA found that: "investors pay more explicit trading costs for active rather than passive funds (10 bps vs 0.5 bps per AUM), due, in part, to the greater research costs associated with active investment." FCA (2016), Asset Management Market Study – Interim Report, p.127

[20] FCA (2016), *Asset Management Market Study – Interim Report* , p.16

The OFT's market study recommended excluding transaction costs from the single charge that it proposed. The OFT was concerned that including transaction costs could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the member's interest.[21] The DWP's analysis when setting the initial charge raised similar concerns. Which? recognises that such concerns might apply in a limited number of scenarios, but not in general. Moreover, predominantly passive investment strategies should not create significant spikes in transaction costs.

Which? welcomes the DWP's and FCA's measures to force asset managers to disclose transaction costs to trustees and independent governance committees. However, in itself, this will not be sufficient to safeguard auto-enrolment scheme members from high transaction costs, especially given the inherent difficulties in scrutinising and comparing transaction costs. It is important to also note that the FCA's new guidelines for the disclosure of transaction costs, which take effect from January 2018, also provide a basis for asset managers to disclose these costs and for a charge cap to be enforced.

The Government should regularly benchmark the charge cap against the level of competitive pension products

Owing to the weak competitive pressure on providers of auto-enrolment pension schemes, the DWP should regularly benchmark the default charge cap against the level of charges in related markets, in particular, for competitive pensions and savings products directly available to consumers or advisers.

Namely, a clear benchmark is the market for self-invested personal pensions (SIPPs) and individual savings accounts (ISAs), especially as many SIPPs and ISAs are delivered in similar ways to auto-enrolment schemes, typically online with a call centre for support, and contain identical underlying investments. However, unlike auto-enrolment schemes, there is a much more competitive market for SIPPs and ISAs. Moreover, if such similar products are available to individual consumers, then even smaller employers, which may lack the bargaining power of larger employers, should also be able to find a pension scheme at least as low cost as these for their employees.

It is important to note that the FCA's asset management market study found that the average Ongoing Charges Figure for a £25,000 ISA investment was around 0.5%.[22] Most ISA providers charge small investors a higher percentage charge of their investment, either via flat fees or a tiered percentage of their investment, which skews the average charges figure.

It is therefore helpful to look at specific firms whose charging structures are lower for smaller investors, including new entrants that have driven downward pressure on charges. The Table below shows two of the lowest cost SIPP and ISA providers for smaller investment sizes, Fundment and Vanguard.

Fundment is a discretionary investment manager available to end clients through authorised intermediaries. Vanguard is the world's second largest asset manager. Both providers offer ISAs and/or SIPPs comprising diversified investment portfolios, primarily of equities and bonds.

[21] Office of Fair Trading (2013), *Defined contribution workplace pension market study*, p.25
[22] FCA (2016), *Asset Management Market Study – Interim Report*, figure 5.6, p.79

Table: Total charges for two low-cost SIPP and ISA providers

Provider	ISA / SIPP	Platform charge	Investment fund charge (Ongoing Charges Figure)	Total charge (including transaction costs)
Fundment[23]	SIPP	-	-	0.35%
Vanguard[24]	ISA (& SIPP launching soon)	0.15%	0.22%	0.37%

The charges for both of these products are less than half the level of the existing default charge cap for auto-enrolment, including transaction costs.

The Government should therefore reduce the default charge cap to close to level of such benchmark products and include transaction costs within the cap.[25]

Which? notes that, when initially setting the auto-enrolment charge cap, the DWP estimated that compared to a cap of 0.75%, which was ultimately introduced, a cap of 0.5% could save consumers £40,500 on average in charges by retirement.[26] Widening the scope of the cap to include transaction costs, as argued below, would mean that consumers would save even more.

It is also important to recognise that not all pension providers may be able to continue to offer auto-enrolment schemes that fall within a lower cap. Some consolidation within the UK pensions sector should benefit consumers, though greater scale economies and incentives to drive down costs. Moreover, a lower charge cap is the most effective way to address the long tail of pension schemes offering poor value for money.

[23] See article "Investment platform starts offering SIPP", *FT Adviser*, September 2017.
[24] Charges shown are for Vanguard's Lifestrategy Funds. Minimum investments are £100 per month or £500 lump sums.
[25] We would also ideally like to see a move a way from the combination charge cap, as this makes comparison between providers difficult, increases switching costs between providers, and penalises members with shorter investment horizons.
[26] Department for Work and Pensions (2013), *Better workplace pensions: a consultation on charging*, p.12

About Which?

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