Keep calm and carry on

With the Department for Work and Pensions' (DWP) consultation on the defined contribution (DC) pension default fund charge cap and standardised cost disclosure having closed on 20 August, Jack Gray analyses the industry's thoughts on the proposals

Summary

- In the government's review of the charge cap in 2017, it made a commitment to re-examine its scope and level in 2020.
- The majority of respondents do not support making changes to the current level of 0.75 per cent within the default arrangements or including transaction costs in its scope.
- However, the consultation did spark debates around the appropriateness of certain charging structures, especially on small pension pots.
- Suggestions for making standardised cost disclosure templates mandatory receive a mixed reception.

In 2017, the government carried out an assessment as to whether the charge cap on DC pension schemes' default funds of 0.75 per cent of funds under management, introduced in 2015, was appropriate. After considering opinions from across the industry, it concluded that the cap was operating as intended and decided to leave it at the level set two years earlier, with a promise to re-review in 2020.

A second consultation ran from 25 June to 20 August 2020, which also sought views on the effectiveness of costs, charging structures and transparency measures in protecting member outcomes.

It appears that most industry experts do not believe the charge cap needs to be lowered, despite the 2016 *Pension Charges Survey* finding average charges of between 0.38 per cent and 0.54 per cent, but the consultation did raise concerns around charging structures and cost transparency.

Lowering the cap

The charge cap's introduction in 2015 has helped protect auto-enrolled savers from complex charging structures and high charges. AJ Bell senior analyst, Tom Selby, describes its introduction as a "necessary response given the dynamics of the market, in which millions of savers make no active choice and therefore exert little, if any, demand-side pressure on the pension provider".

Following the findings in the DWP's 2016 survey, it may be assumed that lowering the cap to around 0.55 per cent would make sense. However, industry experts have expressed concerns that reducing the cap could stifle innovation and good governance as it limits providers' space to develop.

"Do we automatically cut it to 0.55 per cent? No, that is probably not appropriate," says Dalriada Trustees professional trustee, Paul Tinslay.

"We have far more savers going into DC schemes and the sizes of DC pots are going to massively increase over the next decade or so. With that in mind, it would be difficult to say 0.55 per cent at this stage looks good because everybody is there but could realise in three or four years' time that that is not enough."

Tinslay notes that a certain amount of "wriggle room" is required in line with the increasing costs of improving governance and market development, and to help new providers coming into the marketplace.

TPT Retirement Solutions director of DC, Philip Smith, adds: "I could see a situation where if you did lower the charge cap it might slow the introduction of more sophisticated investment strategies.

"I know a lot of people think long and hard about including alternatives in their investment strategies and struggle because it is typically higher than the current charge cap for a lot of alternatives and it would certainly be higher than 0.55 per cent.

"I do not think there is any need to change it. There is a good, healthy level of competition."

A further impact of lowering the charge cap could be an increase in consolidation, as schemes would need a greater scale to operate at the lower price point.

Selby notes that the DWP will be wary of the impact lowering the cap may have of "soft offerings", such as member communications.

Widening the scope

The government's consultation also sought views on whether transaction costs should be included within the charge cap. This was also considered in its 2017 review, with the government concluding that it was not necessary at the time in order to allow the Financial Conduct Authority's (FCA) new rules on transparency to bed in.

Additionally, it was decided that the "difficulties in calculating certain 'implicit' transaction costs meant they should not be included", according to Selby. "Since then the FCA has agreed a measure of transaction costs, so it makes sense for the government to revisit that decision," he adds.

However, in responses to the DWP's most recent consultation, the same concerns around the stifling of innovation and progress have been cited as reasons not to include transaction costs in the charge cap.

"It seems to be clashing with the direction of travel that the industry was trying to head in," explains Barnett Waddingham head of DC and workplace wealth, Mark Futcher. "DC needs to take advantage of economies of scale and therefore be able to invest in different asset classes that we think will generate better returns, control volatility, and increase diversification. But those asset classes come with very different charging structures and strategies."

Futcher warns that the inclusion of transaction costs could make trustees act cautiously, not embrace new ideas and "hunker down" around more traditional investments. Capping transaction costs could mean products that schemes feel deliver better value in the long term may be inaccessible.

Taking the initiative

To improve cost transparency in the pensions sector, the DWP issued proposals to increase the usage of the Cost Transparency Initiative (CTI) templates. The government wanted opinions on whether the templates should be made mandatory, whether trustees should be required to report on their use of CTI templates to The Pensions Regulator, or if they should remain voluntary.

"We continue to struggle to get data in a timely fashion," says Futcher. "Not everyone is using the template that most of the industry agreed on. There were some quite big asks of the fund management industry to put all this data together, they still have not got these systems in place. I would give it a bit more time, but we do need that compliance and transparency over costs."

Tinslay agrees that the adoption of CTI templates should be encouraged, as a uniformity allows for a "meaningful measurement" of transparency, while Smith says he probably "falls on the site of mandatory" but warns this would pose challenges.

"You can make it mandatory, but how easy is it to get hold of the information that you need and how certain are you that it is right?" Smith notes. "I think that is a challenge. It is a challenge for everyone, not just a DC challenge."

Protecting the small

Discussions around charging structures within the consultation has led debates on the issue of the growing number of small deferred pension pots and the impact that certain structures, such as flat fees, can have on them.

"We really need to be addressing the growing issue of small and deferred pots," warns Now Pensions CEO, Patrick Luthi. "Resolution of high numbers of small, deferred pots could, in time, lead to improvements being made in the level and structure of the charge cap."

The rising number of small pots has led to some industry experts, such as LCP, to call for a ban on member borne flat fee charging structures, as they can erode the small amount of savings in these pots.

However, Luthi disagrees: "The answer to the problem of flat charges is not to ban them, but rather to solve the problem of small pots and then to re-examine the case for changing the charge cap and/or its structure. We are calling for the creation of a taskforce and are looking at setting a level below which charges cannot be levied, therefore preventing members' pots from being charged out."

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