Financial Conduct Authority

Consultation Paper CP24/16, The Value for Money Framework

Submission by The Financial Inclusion Centre

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Introduction

We are pleased to make a submission to this important consultation document. For further information, please contact:

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Summary of our position

We are concerned about the degree of emphasis placed by the FCA on investment performance, particularly past performance, in the proposed VFM framework. Not only does this risk suboptimal asset allocation decisions being made based on flawed claims about investment performance, it diverts attention from the most important factor, the impact of charges and costs on pension values.

It also risks causing more pension assets to be invested in high cost, complex, opaque, poorly regulated and governed 'alternative' investment assets and vehicles with questionable past performance track records and future prospects.

The FCA states that: '*We are clear that value for money is not only about a focus on costs and charges – the cheapest schemes to run will not necessarily deliver the best performance in the long term for consumers. Other factors are relevant including the quality of services provided, investment performance and customer experience. The outcome of the proposals that we are consulting on today is to ensure that there is a focus on all of these factors, not only costs and charges.*'

The FCA says it wants to: reduce the number of savers with workplace personal pensions that are delivering poor value; and drive better value for money across the workplace DC market through greater scrutiny and competition on long-term value rather than predominantly cost

The FCA must know that future good investment performance cannot be predicted – past performance is no guarantee of future performance. However, we can model the impact of high charges on peoples' pensions and investments. We know that *ceteris paribus* higher charges and costs reduce the value of the final income. The higher the charges and costs, the more a consumer has to contribute to their pension/ investment to produce the same future fund value.

Superior investment performance may well end up offsetting higher costs and charges. But, that cannot be said to be down to predictable *ex ante* skills on the part of the investment manager, consultants, advisers, and other intermediaries. It is very important for the FCA to recognise that investment based services are not like consumer products or motor cars where the past performance can be used to determine the likelihood of future performance. By allowing past investment performance to be the core of a VFM assessment, the FCA risks misleading pension savers and distorting the market.

We have made significant progress in driving down charges and costs in the UK pensions and investment industry including through the use of the workplace pension charge cap. The weakening of the workplace pension charge cap and now this VFM framework threatens to reverse this

progress. The VFM framework with its emphasis on investment performance will just allow investment managers, consultants, advisers, and other intermediaries to divert attention from the importance of costs and charges and actively promote and sell high cost, complex investment strategies which actually offer little added value but introduce greater risk.

The assumption underpinning the general VFM framework seems to be that this will allow trustees and other governance bodies (IGCs), consultants, advisers, and other intermediaries to drive an improvement in investment performance (and therefore pension outcomes) through the dynamic of competition. Yet, there is no evidence to support this hypothesis. Given that past performance is no predictor of future outperformance, it is difficult to understand why the FCA (and the TPR) thinks the VFM framework will have the desired effect.

Moving the focus away from costs and charges will not promote more effective and efficient competition. It will just allow firms and various intermediaries to use potentially misleading data to promote costly investment strategies. It will promote competition on spurious factors.

Surely, the government, FCA and TPR must recognise the risk that this approach will just create new opportunities for consultants, advisers, and other intermediaries to sell more costly advisory services to schemes as well as a recommend more costly alternative strategies and funds. Rather than enhance value, the combination of more costly assets and advisory services is more likely to reduce pension values.

To be clear, we do not challenge the need for investment firms and various intermediaries to report on past performance. This is an important element of accountability. Investment managers and intermediaries should be required to justify poor past performance and the charges and costs involved. IGCs and trustees should be encouraged to demand lower charges and costs and switch providers where advantageous to drive value for the pension scheme members they represent. IGCs and trustees should be required to justify clearly to scheme members/ investors why they decided to use higher cost investment solutions when lower cost solutions such as passive strategies and funds are available.

We do support the collection and publication of performance data as an accountability tool. A database with performance and charges along with the name of the investment manager and adviser/ consultant should be published by the financial regulators.

The important point is that past performance should not be allowed to influence attitudes and beliefs about future performance and, therefore, the overall VFM of an arrangement. Past performance must be detached from and not be allowed to influence VFM decisions. Costs and charges must be at the core of any VFM assessment.

We do not see any harm in allowing a separate rating of quality of service to be shown alongside clear information on charges and costs. However, rather than hope that this will encourage scheme members and governance bodies to drive competition, it would be much more effective if FCA and TPR used this data to more robustly intervene to drive up standards.

Response to specific questions

Question 1: Do you agree with the proposed scope, thresholds and exclusions? Why or why not? If not, what alternatives would you suggest?

Question 2: Do you agree with the proposed application of the 80% threshold to determine whether legacy arrangements are quasi-defaults? Why or why not? If not, what would you propose?

Question 3: Do you agree with the proposed 1,000 member threshold? Why or why not? Do you think there are risks around this level, for example excluding too many savers? If you don't agree, what would you suggest?

Rather than specify which particular arrangements are to be actively included within the regime, it would be preferable for the FCA to adopt a permissive approach by drafting rules allowing for all relevant arrangements to be included. This does not mean that all the specific rules need to apply to all arrangements immediately. These could be 'switched on' at a later stage if evidence of consumer harm deems it necessary. This would provide for greater flexibility and agility to respond to emerging detriment.

But, note that we do not support the FCA's basic approach to VFM. While we fully support the need for pension arrangements to be brought within the regime to promote greater accountability, there are more effective ways to provide that accountability. The FCA's approach is likely to undermine accountability by moving the focus away from costs and charges to investment performance. Past performance data should be used to report on historic VFM for the purposes of accountability. But, it should not be allowed in any way to imply VFM going forward. Costs and charges should be the focus of any VFM assessment.

If this initiative is to hold investment managers, fund governance bodies, and consultants/ advisers/ intermediaries to account, then clearly benchmarks on charges and costs should be included to allow for comparison.

Investment performance

Question 4: Do you agree with the proposed investment performance metrics? Why or why not? If not, what alternatives would you suggest?

We have no particular comment on the metrics. However, we do not understand why the FCA is not proposing that the actual investment and ongoing administration charges be disclosed along with benchmarks.

Question 5: Do you agree with the proposed calculation methodology? Why or why not? If not, what alternative methodology would you suggest?

Yes, we agree with the proposed methodology. However, we would recommend that these proposals be tested with pension scheme members to gauge levels of understanding and usefulness.

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Question 6: Do you agree with the proposed requirement for chain linking? Why or why not? If not, what would you propose?

Yes. This is an accepted approach to performance measurement.

Question 7: Do you agree with the approach to in-scope legacy arrangement features? Why or why not? If not, what alternative approach would you suggest?

No comment.

Question 8: Do you have further feedback on the incorporation of forward-looking metrics within the Framework? If included, how prescriptive do you think we should be on assumptions and methodology, and what would you propose?

It is very worrying that the FCA is not mandating the use of forward-looking metrics from the outset. As explained, there is little/ no relationship between past good performance and future performance. The inclusion of good past performance data should not be allowed to imply the prospect of good value going forward especially to downplay the impact of high costs and charges.

Costs and charges matter. Future good investment performance cannot be guaranteed nor should be implied by past performance data. The effects of high costs and charges can be modelled and should be presented. The FCA should mandate the use of standardised projected returns for asset classes and standardised projected real returns for total portfolios (based on the current asset allocations) showing:

- the impact of costs and charges on those returns (the reduction in yield)
- the impact on pension values over relevant time periods
- the total costs and charges extracted annually and cumulatively
- a comparison against benchmarks

Asset allocation disclosures

Question 9: Do you agree with the approach to asset allocation disclosures? Why or why not? If not, what would you suggest? Do you think asset allocation disclosures will support better decisions in the interests of savers?

Yes, the approach to asset allocation disclosure seems sensible. It would be worth testing this in depth with the intended audience.

It is open to question whether this will drive better outcomes for savers. It all depends on how the FCA mandates the use of asset allocation disclosures. If firms are required to disclose clearly the costs and charges on alternative, illiquid assets (which tend to be higher than those on mainstream assets) and the impact of those costs and charges on the standardised projected overall portfolio returns then this could support better decision making. This could be done by using a fairly straightforward asset allocation/ cost attribution matrix.

However, it could just as easily promote sub optimal behaviours if it is allowed to be exploited by firms to justify investment in high cost alternative assets through the use of suspect past performance data.

Question 10: Do you agree that asset allocation disclosures should be limited to firm designed in scope arrangements only? Why or why not? If not, how would you broaden this requirement and to what arrangements?

No. This should also apply to bespoke arrangements. Operators of bespoke arrangements are likely to be susceptible to being poorly advised by consultants/ advisers to invest in high cost alternative investments.

Question 11: Do you agree that we should require the disclosure of the overall asset allocation of the whole arrangement, as well as for the YTR points? Will this be of use to firms, and will it be an added burden to disclose?

Yes. It is important that stakeholders can see the full extent of the value extracted from pension arrangements through the imposition of high costs.

Question 12: Do you agree with the proposed definitions for UK assets? If not, what would you propose?

No comment.

Question 13: Do you think we should break out 'Quoted but not listed' (eg AIM) and if so, how would that be useful? Would there be additional cost to doing this and can you indicate how much?

We have no real comment to make on this other than to say that if policymakers want to understand the degree to which financial markets are supporting smaller companies then more granular disclosure would provide greater insights.

Costs and charges

Question 14: Do you agree with the proposed costs and charges metrics? Why or why not? If not, what alternative metrics would you suggest?

Question 15: Do you agree that historic costs and charges information should be calculated in the first year of implementation, rather than waiting for this data to build over time? Please explain your answer. If you do not agree with either approach, what alternative would you suggest?

The first thing to say in response to this question is that is concerning that the FCA states: '*We intend this, together with the asset allocation disclosures for firm-designed defaults, to support firms and IGCs in considering more expensive asset classes, and allow them to demonstrate that charges support investments that have the potential to deliver better risk-adjusted returns for savers over the long-term.*'

It is not the job of the FCA, the financial regulator, to create the conditions for investment managers and investment consultants/ advisers to sell higher cost investment products and strategies. To reiterate, future outperformance cannot be guaranteed but we do know that *ceteris paribus*, the higher the charges and costs, the greater the negative impact on pension values. If the FCA is concerned about VFM, it should be focusing on driving down charges not actively enabling the selling of higher cost, more complex solutions investment solutions which offer little or no added value but introduce greater investment and governance risks.

We disagree with the intention to disapply requirements to disclose certain transaction and administration costs. Transaction costs should be included in the definition of investment costs. This could be done by requiring firms to add back in these costs to the current approach which shows 'gross' investment performance net of charges to show true gross performance.

However, the main point here is that costs and charges matter. Changing the focus to performance and downplaying costs and charges will be to the detriment of pension savers. So, all charges and costs should be disclosed to allow for a true comparison of VFM.

With regards to disclosing the impact of charges and costs, as outlined above, the FCA should set standardised projected return rates for portfolios and require firms to display the reduction in projected returns caused by total costs and charges (akin to a reduction in yield) and the cumulative impact on pension values.

We argue that the overall priorities of any reform should be to:

- enhance the efficiency of the pensions and investment industry by driving down charges and costs
- hold the pensions and investment industry to account through greater transparency; and
- promote competition on what matters, costs and charges, by demonstrating the impact of industry costs and charges on future pension values.

This means displaying historic data on the effects of charges and costs on pension values and also providing assessments of future impacts on pension values.

It is particularly important to show the impact on those with low contribution levels. Therefore, firms should be required to use three different contribution level scenarios and show the impact of total arrangement costs and charges on projected pension values.

We agree that total costs and charges should be displayed in the first year of implementation. The current level of charges and costs should then be used to calculate and display the impact on projected returns and pension values as a reduction in yield.

But, if we are to have proper accountability, historic data should be gathered and presented on all types of arrangements as soon as is possible.

Question 16: Do you agree with our proposed approach to converting combination charging structures to annual percentage charges? Why or why not? If not, what alternative would you suggest?

With regards to combination charges, the FCA suggests in para 6.26 that 'a firm may also choose to disclose an estimate of total costs and charges, expressed as a percentage……. We do not think this should be a 'may' choose. Firms should be *required* to show the effect of total charges and costs on projected returns (as a reduction in yield) and on pension values over relevant periods.

Question 17: Do you agree with the proposed approach to unbundling? Why or why not? If not, what alternative would you suggest?

As above, current total charges and costs should be calculated and used to calculate the impact on standardised projected returns in the form of a reduction in yield. Historic data should be collected and disclosed as soon as is possible.

Question 18: Do you agree with the proposed approach to multi employer cohorts? Why or why not? If not, what alternative would you suggest?

No comment.

Quality of services

Question 19: Do you agree with the proposals on scope? If not, what alternative approach would you suggest?

Question 20: Do you agree with the five proposed indicators of service quality? If not, what alternatives would you suggest, with metrics?

Question 21: For each of the five proposed indicators, do you agree with the proposed metrics for measuring these? If not, what metrics would you suggest? We would particularly welcome views on these metrics.

Question 22: Do you agree with our proposal to include a non-employer related email address and phone number when defining common data? If you don't agree, please explain why not.

Question 23: Do you agree with our proposals for an event-based member satisfaction survey? We would particularly welcome feedback on the trigger events and proposed questions.

Question 24: Do you think that a firm should be able to provide a saver specific view of access to tools and saver use across its digital offerings? If not, what metric would you suggest?

We have no particular comments on the detailed proposals in Q19-Q24.

We make some general comments. If firms are required to gather data, the question arises of what should be done with that data. If the collection of data is to have an impact then the relevant governance body would have to be held to account for failing to ensure decent service levels. This would require some form of public central database of scheme performance.

This would help scheme members compare the performance of their scheme against its peer group. More importantly, the FCA should be mandating that firms within its remit comply with minimum standards on service. Good service should be a common standard across the sector. Relevant fund governance bodies should be required by regulation to take action where there is evidence of poor service standards. A central database would help the FCA supervise firms to ensure standards of service are driven up.

Assessment and outcomes

Question 25: Do you agree with our proposed conditions for the selection of comparator arrangements? If not, what would you suggest?

Question 26: Do you agree with the assessment process we have outlined above? Do you have views on what should be considered a material difference in value relative to comparator arrangements? If you think that RAG ratings 80 will not be sufficiently comparable, what refinements would you suggest?

We are very concerned about the FCA's approach to this. Of course, poor investment performance should be highlighted. But, there is a very real risk that the FCA's approach will enable good past performance (which does not predict future performance) to influence assessment of value for money. It would be quite misleading for an IGC to present an arrangement as offering good VFM just because it happened to have produced good past performance. As mentioned, we are not talking about consumer products or motor cars here where past performance (and consumer testing) can be used to determine the likelihood of good future performance.

Moreover, the basis of the FCA's (and the Government's) approach seems to be that pension savers would benefit if more of their pension savings were allocated to alternative assets. Yet, the claims of alternative asset superior past performance is very questionable not least due to the methodologies employed to calculate performance.

It is of even greater concern that the FCA does not intend to require that investment charges be included in a RAG assessment. Costs and charges matter. To reiterate yet again, past good performance is not a reliable indicator of good future performance. Charges and costs are an indicator of performance as can be seen by the numerous analyses which demonstrate how high cost active management underperforms low cost passive investment.

Past performance should not influence a VFM assessment going forward. Whereas the impact of charges and costs on pension values can be modelled with a high degree of certainty and ought to be the centrepiece of any VFM assessment. IGCs should be required to evaluate total costs and charges against relevant benchmarks included model portfolios of passive funds.

It follows that asset allocation should also form part of the VFM assessment. A greater allocation to higher cost 'alternative assets' will by definition impact on pension values. There is no reason to expect that the impact of these higher charges will be offset by superior future investment performance. The past performance claims relating to alternative assets are questionable due to the methodologies employed to calculate returns.

More importantly, there is no guarantee that the historic conditions that might have made these alternative assets attractive in the past will be maintained going forward. However, these alternative assets/ funds do represent a higher risk in terms of liquidity, poor governance, and opacity.

Therefore, it is very important that the impact of decisions to allocate a higher proportion of assets to more costly, higher risk alternative assets/ funds which offer little by way of superior investment performance be disclosed to scheme members.

Question 27: Do you agree that a multi-employer arrangement should be rated amber if it fails to deliver value for a material number of savers in relation to at least one employer cohort? If not, what would you suggest?

No comment.

Question 28: Do you have any concerns about our proposals for assessing bespoke in-scope arrangements? If you do have concerns, please explain them. If you anticipate negative effects, what can be done to address those?

We don't understand the issue about bespoke arrangements. If the FCA focused on costs and charges, it should be a fairly straightforward quantitative mechanical process to assess the potential impact of costs and charges depending on the particular asset allocation of that arrangement.

Question 29: Do you agree that IGCs should consider and report on whether their firm's current scale may prevent it from offering value to savers? If not, what would you propose?

Yes. As explained above, costs and charges are paramount. As a general principle, larger arrangements should be able to produce economies of scale which in turn should deliver lower costs. Of course, gains from economies of scale could be reduced if governance bodies approve the use of more complex investment strategies involving more costly alternative assets. Larger schemes are more likely to diversify into more costly, complex alternative assets. So, the advantages of achieving economies of scale could be reduced.

Question 30: Do you agree that IGCs should consider how ESG considerations have been taken into account across firm designed in-scope arrangement? Do you think this is sufficient and if not, what would you suggest?

The FCA is expected to play a key role in supporting the UK Government's Green Finance Strategy. UK financial markets need to be realigned with net zero goals. The application of the VFM framework is a good opportunity for the FCA to improve the level of transparency on how much climate harm financial institutions are financing. Therefore, we would argue that IGCs should be required to report on how much climate harm a pension arrangement is financing. Where the firm is not collecting sufficient data to make an assessment of the climate harm financed, the IGC should clearly state this and warn scheme members that it is unable to report on the climate performance of the firm.

Actions for arrangements offering poor value

Question 31: Do you agree that firms should inform employers of amber and red ratings and proposed steps to address the poor value, where an employer's current and past employees are at risk? If not, why not and what would you suggest?

We agree that employers should be informed of amber and red ratings. However, we are unclear why the firm should inform the employers. As the IGC is meant to be the governance body, it would be preferable if the information about the rating came from the IGC.

Of course, this all depends on the how independent are the members of the IGC. But that is another matter.

Question 32: Do you agree that firms should not be allowed to accept business from new employers into an arrangement rated amber or red? If not, why not and what would you suggest?

Yes. But, as explained above, investment performance should not be included in an assessment. Past good performance could skew an assessment and make a high cost arrangement look like it represents good value. This past performance cannot be seen as a predictor of future performance. The use of past performance would misrepresent the VFM.

Question 33: Do you agree with our proposed actions and timings for firms with arrangements rated amber or red? If not, what alternative approach would you suggest?

Yes, in general we agree with the proposed actions and timings.

However, we have concerns about the proposed action plans for improvements if the improvements relate to investment performance. For example, with the FCA's proposals an arrangement might be considered to offer poor value if the past investment performance is poor. The FCA would require an action plan. But, this action plan might include proposals to invest in riskier, higher cost assets or investment funds which up to that point appear to have delivered superior past performance. To reiterate, past investment performance is not a predictor of future performance. So, there is a risk that the action plan would end up moving the arrangement into assets just about to enter a period of underperformance.

Question 34: Do you think that we should require firms to transfer savers out of red-rated arrangements, subject to enabling legislative changes? What are the costs associated with the proposed actions and are they proportionate? If you don't agree with our proposed actions, what would you suggest?

Yes, we agree. We do not have access to the necessary information on costs associated with the proposed actions.

Question 35: Do you think that requiring transfer from arrangements could benefit one group of savers to the potential detriment of others? If so, please explain and can you suggest an approach that doesn't risk detriment to some savers?

No comment.

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Disclosure requirements

Question 36: Do you agree with our proposals for how the Chair's annual reports should be expanded to include the results of VFM assessments? Are there any proposed elements that in practice would not be useful?

Yes.

Question 37: Do you agree with requiring a narrative explanation for the RAG rating for all firm-designed in-scope arrangements including those rated green? Do you think this requirement should be limited to amber and red ratings?

Yes, we think it should include those rated green. But, again, it is important to reiterate that past investment performance should not be included in the rating as this would be misleading.

Question 38: Should IGC Chairs be required to produce a plain-language summary of their reports?

Yes.

Question 39: Do you agree with the need for a features table and the contents we are proposing? Are there changes we should consider? Do you think that the disclosure requirements for bespoke arrangements should be different and if so, in what way?

Yes, we agree there should be a features table. The FCA should specify the format of any table published to allow for easy comparison.

Question 40: Do you agree with our proposed approach to publication including requiring publication of a flat file? What other solutions would best support the aims of the Framework in due course?

Question 41: Do you think we should require machine-readable RAG ratings and potentially other information from the IGC Chair's annual report? What do you think are the benefits and costs or possible negative effects of this?

We agree with the requirement to publish a flat file and machine-readable RAG ratings and relevant information. Rather than wait for the market to develop a database, the FCA should create an accessible database. This should include data for each arrangement particularly charges and costs, quality of services ratings, and past performance data (as mentioned, past performance data should be published in the interests of accountability but not used for RAG assessments).

Amendments to current Handbook requirements

Question 42: Do you agree that the proposed new rules should be under existing requirements for IGCs, with carve outs as appropriate? If not, what alternative approach would you suggest?

No comment.

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Question 43: Do you have suggestions for further amendments to existing requirements for IGCs and if so, why do you think these are needed?

No comment.

Question 44: Do you agree that we should exempt "accidental workplace SIPPs" from COBS 19.5 and the requirement for an IGC or GAA? If not, what would you propose?

No comment.

Future development

Question 45: How do you think the use of data will evolve and what other measures may be needed?

Question 46: We invite views on the roll out, evolution and future phases of the framework, over what time periods, and on the correct sequencing of these developments.

We would welcome the extension of the use of data to all types of pension schemes.

Cost benefit analysis:

Question 47: Do you have any comments on our cost benefit analysis?

We have no comments on the CBA except to reiterate the point that putting so much emphasis on past performance runs a serious risk of creating unintended consequences. Publishing past performance data is important for accountability but it should not be used to influence future decisions. The most important factor remains costs and charges.

This marks the end of Financial Inclusion Centre submission

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About The Financial Inclusion Centre

The Financial Inclusion Centre (FIC) is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

Promoting system level change

Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

Ensuring households' core financial services needs are met

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform. We focus on households who are excluded from, face discrimination in, or are underserved by financial markets and services.

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