FairPensions™
The campaign for **responsible** investment

Response to DWP Select Committee Call for Evidence: Governance and best practice in workplace pensions

Executive Summary

The investment objectives pursued by DC pension providers – usually short-term outperformance against a benchmark – may not be well suited to the interests of pension savers. In particular, this trading mentality discourages **investor stewardship**, i.e. active oversight of investee companies – including in relation to environmental, social and governance (ESG) risks.

Our research suggests that commercial pension providers lag behind the rest of the industry in this area. More generally, it provides evidence of a **governance gap** in contract-based pension arrangements: the absence of fiduciary obligations appears to be reflected in an assumption that commercial providers have little or no role in monitoring asset managers to ensure good outcomes for consumers.

Portfolio turnover (**churn**) and associated transaction costs are currently highly opaque and must be encompassed in any measures to ensure greater transparency of costs and charges.

We are supportive in principle of **NEST acting as an aggregator scheme** as a means of dealing with small pots, since this seems most likely to safeguard good consumer outcomes.

There is ample evidence that **small schemes suffer from weaker governance and higher costs per member** than larger schemes. Consolidation should be encouraged but more must be done to ascertain how this can be achieved in practice.

1. FairPensions is a registered charity that promotes Responsible Investment (RI) by pension schemes and fund managers, and seeks to ensure that savers are well served by their agents in the City. We concentrate below on the aspects of this inquiry's terms of reference which are relevant to our area of expertise.

Managing investment risk and security of returns

Responsible investment and stewardship

2. There is growing concern that the investment objectives pursued by DC pension providers – usually short-term outperformance against a benchmark – may not be well suited to the interests of pension savers in stable and sustainable long-term returns. Narrow interpretations of fiduciary duty exacerbate this problem. There is a widespread assumption that trustees will breach their obligations if

they cannot demonstrate that they are maximising returns relative to their peers on a quarterly basis – despite mounting evidence that this may not optimise performance in the long run.[1] In addition, the duty to invest prudently is interpreted relative to the behaviour of other investors – exacerbating herding behaviour and resultant market volatility which ultimately hurts savers. As an example, before the dotcom bubble burst in 2000, mainstream interpretations of fiduciary duty dictated that pension funds should sack asset managers who were not investing in tech stocks, since they underperformed their peers in the short-term – even though this was a prudent strategy which would have improved the fund's performance in the long run. Our recent report, *'The Enlightened Shareholder',* calls for clarification of the scope of fiduciary duties to help prevent these perverse outcomes.

3. Such approaches also lead to a neglect of activities which may not have a demonstrable and immediate financial impact but are vital to long-term performance – such as monitoring environmental, social and governance (ESG) risks, or engaging in active stewardship of investee companies. One recent study using quantitative modelling found that integrating ESG factors into equity allocation gave a risk reduction of around 30% over a 20 year period at the same level of expected return. A 2011 study by Mercer focussing specifically on climate change policy concluded that it could contribute as much as 10% to overall portfolio risk. Other studies have compared the actual historical performance of funds which integrate ESG with those which do not, and have tended to find small positive correlations.[2] Recent experience also clearly demonstrates the potential for management of ESG risks to impact performance both at company level (e.g. the Gulf of Mexico oil spill, which caused BP to cancel its dividend for the first time since WWII) and at portfolio level (e.g. excessive risk-taking in the banking sector in the run-up to the financial crisis).

4. In the aftermath of the banking crisis, the need to improve the quality of engagement between investors and companies has been increasingly recognised, most notably with the publication of the UK Stewardship Code for institutional investors.[3] There has been widespread take-up of the Code among asset managers and large occupational pension schemes, although there is clearly a long way to go in translating this into meaningful improvements to engagement. Contract-based pension providers, meanwhile, appear to lag behind on stewardship and responsible investment. In our recent survey of the ten largest commercial pension providers,[4] only one (Aviva) had signed up to the Stewardship Code, and only one (AEGON) had a publicly available responsible investment policy. This gap has the potential to adversely affect savers.

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[1] See Vayanos & Woolley, 18 January 2012, 'New light on choice of investment strategy', http://www.voxeu.org/index.php?q=node/7530; Vayanose & Woolley, 2011, 'A Theoretical Analysis of Value & Momentum Strategies', Working Paper, London School of Economics. Available at http://personal.lse.ac.uk/vayanos/WPapers/TAMVS.pdf.

[2] For full references, see FairPensions, 2010, *'Protecting our Best Interests: Rediscovering Fiduciary Obligation'*, p61

[3] FRC, UK Stewardship Code 2010, available online at http://www.frc.org.uk/images/uploaded/documents/UK Stewardship Code July 20103.pdf

[4] FairPensions, 2012, *'The Stewardship Lottery'*

5. The Committee's report on auto-enrolment noted that the criteria for providers of auto-enrolment vehicles "*appear relatively light*" and that there may be a need to strengthen them. We suggest that this could include a requirement to sign up to the UK Stewardship Code, in recognition of the importance of good stewardship to the stable and successful capital markets that will underpin long-term returns for pension savers. The Financial Reporting Council should also be encouraged to strengthen the Stewardship Code and to ensure that signatories demonstrate meaningful commitment to engaged and responsible ownership.

How to strike an appropriate balance between regulation, self-regulation and good governance

Fiduciary obligations and the 'governance gap'

6. In our response to the Committee's previous enquiry on auto-enrolment, we raised concerns about unevenness in the quality of governance and the potential for this to adversely affect member outcomes. In particular we highlighted the imbalances between trust- and contract-based pension providers in respect of the fiduciary obligation to act in savers' best interests. As argued in paragraph 5 above, interpretations of this vital legal principle have narrowed over the years, and clarification is needed to reassert their basic purpose of ensuring that intermediaries act in the long-term interests of those they represent. But there is also a need to clarify to whom these duties apply. It is commonly assumed that fiduciary duties apply only to trustees, and not to the range of intermediaries who increasingly take investment decisions on their behalf – still less to contract-based pension providers. We have sought clarification of the government's position on this issue during the Financial Services Bill's passage through parliament, but the Minister's response has to date been disappointing.

7. Our recent survey of commercial pension providers offers practical evidence of the 'governance gap' feared by commentators such as the Workplace Retirement Income Commission. Most providers appeared to regard their role as that of a platform or 'fund supermarket', rather than as that of an asset owner with ongoing responsibilities to oversee the quality of investments being made on clients' behalf. This was reflected in their stewardship practices: many respondents appeared to rely on the policies of their internal asset management arms, with only one monitoring the voting activities of external asset managers. The survey concludes, "*There is no sense that insurance companies view themselves as having a responsibility to regularly monitor fund managers on their 'stewardship' of investee companies to ensure that they are well-governed and deliver sustainable returns for customers.*"[5] It seems likely that this is not unique to stewardship but reflects a wider gap in investment governance.

Transparency of charges and costs

8. Evidence suggests that higher charges cannot be explained as a reflection of better performance. A survey by consultants Lane Clark & Peacock found little

[5] FairPensions, 2012, *The Stewardship Lottery*

correlation between the level of fees charged by managers and the degree to which they outperformed the market, with even performance-related fee bases "*skewed in the managers' favour*".[6] It also found that market performance rather than manager skill was the main driver of fee increases – so a manager who underperformed the market by 2% in 2010 could still expect a 20% increase in fees. This suggests that policymakers are right to be concerned about high charges, since they do often amount to an erosion of pension savers' returns rather than the fee for a superior service.

9. One aspect of costs where there is a lack of transparency is the transaction costs associated with portfolio turnover, or 'churn' (i.e. excessive trading of assets). Some equity funds being marketed to UK pension schemes have turnover levels of more than 300% pa.[7] Research by Money Management suggests that fees and charges can reduce long-term performance by around 35%, but that the 'hidden costs' associated with portfolio turnover could increase this to 53%.[8] Similarly, Professor Paul Woolley of the LSE has calculated that a turnover rate of 100% could erode the value of a pension by around 1% a year. He concludes: *"Pension funds are having their assets exchanged with other pension funds at a rate of 25 times in the life of the average liability for no collective advantage but at a cost that reduces the end-value of the pension by around 30%."*[9]

10. Turnover has been highlighted by The Pensions Regulator as a key factor for trustees to understand in controlling scheme costs, and one not captured in Annual Management Charges or Total Expense Ratios.[10] Yet we have heard anecdotal evidence that trustees have been unable to access information about the costs of portfolio turnover from their fund managers when they have asked for it.[11] Turnover must feature in any proposals to improve transparency of costs and charges.

The government's proposals for managing small pension pots

11. In principle we support the idea of NEST acting as an aggregator scheme. Due to its strong governance arrangements and low charges, this seems more likely to safeguard good consumer outcomes than a system whereby pots travel with savers from job to job. The latter system relies too much on savers to understand whether the new scheme offers a better or worse deal than their existing scheme, and to opt out of transferring if it is worse. Default transfers into NEST would make it simpler for individuals to judge the implications of transfers, but would also guarantee a minimum standard of governance for the majority who would not make an active choice. As discussed above, an alternative way of guaranteeing this minimum standard would be to strengthen the qualifying criteria and/or to clarify the obligations of contract-based providers. Our full

[6] Lane Clark & Peacock 2011, '*LCP Investment Management Fees Survey*'
[7] See FairPensions, 2010, *Protecting our Best Interests: Rediscovering Fiduciary Obligation*, p124
[8] See www.parliament.uk/briefing-papers/SN06209.pdf
[9], Woolley P., 2010, '*Why are financial markets so inefficient and exploitative, and a suggested remedy*', in LSE, The Future of Finance, p134. http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter31.pdf
[10] http://www.thepensionsregulator.gov.uk/docs/dc-discussion-paper-2011.pdf
[11] See FairPensions, 2010, '*Protecting our Best Interests: Rediscovering Fiduciary Obligation*', p125

response to the government's consultation on small pots can be found at http://www.fairpensions.org.uk/policy.

Whether greater economies of scale within the sector could produce better value for money for members and if so, how this can be achieved

12. In 2010 there were 44,000 DC schemes with less than 12 members. These schemes accounted for over 90% of all schemes but just 5% of all members.[12] As recently noted by The Pensions Regulator, *"survey evidence suggests that the smallest schemes are less likely to benefit from good governance."*[13] A recent OECD paper expressed concern that small schemes "*may be more exposed to conflicts of interest and be at the mercy of consultants and external advisors who may lead them to make risky investments that they may not fully understand."*[14] Smaller schemes may also find it difficult to engage in active stewardship: they may receive less full reporting from their asset managers or be told that their fees are insufficient for the asset manager to engage with companies on their behalf. They are more likely to invest in pooled funds, thereby losing rights to instruct on how their shares should be voted.

13. Costs per member of scheme administration have been shown to be more than twice as high for schemes with less than 2,000 members as for those with more than 10,000 members.[15] Recent DWP research found that the mean annual cost of employing asset managers was £96 per member for schemes with less than 100 members and £59 for those with more than 10,000 members; independent financial advisors were over eleven times more expensive per member for the smallest schemes compared to the largest.[16]

14. Given the governance challenges and higher costs faced by these schemes, it is difficult to see how their trustees are truly able to act in members' best interests. Measures to encourage consolidation could therefore reap significant benefits for pension savers, both through improved governance and through lower costs. How this could be achieved is a more difficult question. Concerningly, DWP does not appear to have commissioned any work on this question to date. Experiments in consolidation, such as that recently announced by the London local authority pension schemes, could offer lessons about how the legal and practical barriers associated with consolidation can be overcome.

[12]TPR, 2010, '*DC Trust: A presentation of scheme return data*', p 4

[13]TPR, February 2011, '*Enabling good member outcomes in work-based pension provision'*, para 11 (p7)

[14]Stewart, F. and J. Yermo (2008), '*Pension Fund Governance: Challenges and Potential Solutions*', OECD Working Papers on Insurance and Private Pensions, No. 18, OECD publishing; p13

[15]Capita Hartshead, 2010, 17th Annual Pensions Scheme Administration Survey.

[16]DWP, 2010,'*Working Paper 91, Pension Scheme Administration Costs*', p6