Linklaters

IGC Annual Report Review

Introduction

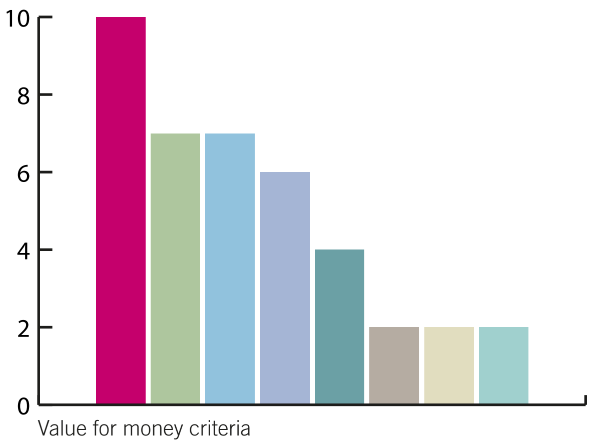
Since 6 April 2015, the Government has required all DC workplace pension schemes to comply with minimum governance standards in order to improve outcomes for individuals at retirement. In a contract-based context, the Financial Conduct Authority ("FCA") has required all providers of workplace pension schemes to appoint independent governance committees ("IGCs") to provide governance oversight of their schemes. IGCs are required to act solely in the interests of scheme members and assess the value for money for members delivered by their providers' schemes. They are required to produce an annual report assessing compliance with their regulatory obligations.

IGCs were required to publish their first annual reports by 6 April this year. Since then, the Linklaters Pensions Group has reviewed a sample of 10 publicly available reports from IGCs of key providers in the industry to identify common trends and issues. We have kept our review purposefully high-level and focussed on the following key areas addressed by each IGC: (i) criteria for assessing value for money; (ii) treatment of legacy funds; (iii) transparency of transaction costs; and (iv) next steps.

Overleaf, you will find a comparison table of the IGCs' annual reports in our sample.

If you would like to discuss our review, or issues relating to IGCs generally, please get in touch with your usual Linklaters' Pensions Group contact.

Sample of ten annual reports from IGCs of key providers in the industry



Assessing good value for members

The graph bottom left sets out the range of criteria IGCs have used in assessing value for money. The left hand side of the graph shows the number of IGCs in our sample which used the criteria set out on the right hand side of the graph. For comparison purposes, we have generalised the value for money criteria.

Unsurprisingly, all ten IGCs in our sample used charges and costs as one of their criteria. Seven IGCs adopted investment, either in the form of investment options or returns. Seven IGCs used administration; and six adopted communications as criteria.

Broadly, our research shows that as a starting point, IGCs compared the charges and transaction costs paid by members against what members actually get from their contributions in the form of investment returns. However, value for money goes beyond a simple assessment of charges and investment returns and looks at the quality of the "services" and "benefits" provided to members. This approach reflects the Pensions Regulator's ("TPR") minimum assessment criteria set out in the draft DC Code due to be published in July this year: (i) scheme management and governance; (ii) administration; (iii) investment governance; and (iv) communications. Not only does this show alignment of policy making between the FCA and TPR, but also synergy of thinking spanning contract and trust-based schemes in the industry.

Other areas considered by IGCs were customer feedback, with one IGC basing their entire criteria on customer feedback, product suitability and the flexibility of options offered to members.

The majority of IGCs did not include decumulation in their value for money assessment. However, one IGC did review charges in respect of its drawdown products and this is an area we see developing this year.

- Charges and costs
- Investment options/returns
- Administration
- Communications
- Default strategies
- Product suitability
- Customer feedback
- Flexibility and access

Provider	Value for money?	Value for money criteria	Legacy arrangements	Transaction costs disclosed?	Next steps
1. Aegon UK	Yes	Value for money criteria based on customer research: 1. Fair charge for services received. 2. Valuable investment solutions. 3. Quality benefits and services. 4. Communication and engagement with customers.	Reviewing legacy arrangements and moving the administration of customers' policies to more modern systems with lower charges and more interactivity.	No	> Benchmarking. > Treatment of small funds. > Move to digital platforms. > Request and review transaction costs. > Review appropriateness of default investment strategy.
2. Aviva	Yes (reviewed 94% of policies in remit)	1. Service and Administration. 2. Communications. 3. Product Charges and Costs. 4. Product Design and Suitability. 5. Investment Choices and Returns.	Aviva have removed certain charging practices, including active member discounts, commissions and consultancy charging.	No	> Detailed review of the remaining 6% of products in remit. > Review of default funds. > Focus on transaction costs. > Assess other charges including exit fees. > Communications and member engagement.
3. Friends Life	In part (once recom-mended actions imple-mented)	1. Product charges. 2. Fund performance. 3. Service and administration. 4. Communications. 5. Lifestyling options.	Less than 1% of all Friends Life's Workplace Pension customers are in older, higher charging arrangements. Policy Fees will be removed. The IGC has adopted the IPB benchmark of 1% per annum for legacy schemes.	No	> Focus on transaction costs. > Make improvements for actives where charges remain above 1%. > Review of exit charges. > Customer feedback on good value.
4. Legal & General	In part	1. Price (any costs). 2. Default investment strategies. 3. Returns on investments. 4. Flexibility. 5. Administration. 6. Communications. 7. Customer feedback.	Members not charged to cover commission payments in funds outside default.	No	Lot of room for improvement to demonstrate value for money: > Monitor any breach of charges cap and request prompt action. > Review default investment funds and strategy. > Ensure other investment strategies in members' interests. > Review opportunities of investor to access funds. > Review effectiveness of IGC.
5. Old Mutual	Yes	1. Default investment strategy. 2. Review of investment performance. 3. Processing of financial transactions. 4. Costs and charges.	Limit early encashment charges relating to products taken out pre July 1999 to 5% (max) for policyholders over the age of 55 taking their savings after 1 April 2016.	No	> Reduce early exit charges and waive Contribution Servicing Charge. > Review appropriateness of range of default strategies. > Old Mutual to review adviser-commission payments and report to the IGC. > Review of investment strategies for non-contributors. > Customer feedback.
6. Prudential	In part (majority of members getting value for money)	The IGC considered four factors: 1. Investment returns. 2. Charges. 3. Service. 4. Communications. Investment returns and charges given the most weight.	Eliminate impact of initial charges, remove loadings for commission and cap annual policy fees at £24p/a. Simplify charging structures and reduced charges for legacy schemes.	Some information. Assessed investment returns after all charges, including transaction costs, have been taken into account. No breakdown of costs.	> Make communications to members easier to understand. > Improve value for money by looking at where and how money is invested. > Reduce charges by an average of 15% and remove all exit charges. > Prudential to contact members who self select and carry high charges, and small pot members.

Provider	Value for money?	Value for money criteria	Legacy arrangements	Transaction costs disclosed?	Next steps
7. Royal London	Yes	Value for money principles: 1. Ongoing charges must offer value for money. 2. Communication with customers must be clear, timely and helpful. 3. Workplace pension contracts should be regularly reviewed for relevance. 4. Any deductions from pensions must be fair and designed to recoup unrecovered costs by Royal London caused by customers' early exit. 5. Any assessment of value for money should make allowance for the need for some cross-subsidies. 6. Assessment to consider the impact on Royal London.	IGC has considered IPB report, which has led to planned changes by Royal London and to future work on transaction costs.	Yes. Direct costs applicable to its most popular investment funds, but no indirect costs.	> No member charge when a member's plan is paid up. > No exit charges for deferred members. > Charges only to recoup commission cost. > Extend increases to loyalty bonus payments until member's retirement date.
8. Scottish Widows	In part (reasonable value for money relative to the market)	1. Default investment options. 2. Important administration functions. 3. Customer support. 4. Charges.	Cap of 1% on legacy arrangements. Exit penalties to be removed.	Some information. Total costs borne by funds and information on impact of costs on growth of funds.	> Ensure charges cap compliance and remove exit penalties across older legacy schemes. > Maintain service levels against Scottish Widows' published standards. > Deliver new digital communications. > Engage customers earlier on retirement options. > Customer research. > Scrutinise levels of transaction charges. > Review governance of non-default funds.
9. Standard Life	Yes	The IGC focussed on four core elements: 1. Quality (service and investment. 2. Risk (investment and governance). 3. Relevance (including member feedback). 4. Cost.	Where current charges are over 1% because Standard Life is recouping commission previously paid to an adviser, Standard Life will cap the total cost at 1%.	Some information. Range of transaction costs in certain default funds between 0.1% to 0.2%.	> Charges cap of 1% unless members choose more expensive options. > Review investment options and default arrangements. > Seek increased transparency of charges and transaction costs. > Cap on early exit charges. > Establish industry criteria for benchmarking.
10. Zurich	In part	Value for money criteria as laid down in Zurich's 2014 review. IGC focussed on: 1. Members exposed to high charges. 2. New joiners exposed to high charges. 3. Members exposed to charges when they leave or switch pensions.	Action taken in relation to charges for members when they leave or switch pensions.	No	> Consumer research to better assess value for money in a consumer focussed way. > Upper limit on charges. > Switching small funds. > Move to digital platforms. > Review charges in legacy schemes.

Disclosure of transaction costs

Transaction costs are defined under statute as costs incurred as a result of buying, selling, lending or borrowing of investments and, broadly speaking, they are costs linked with the process of investing in order to generate a return for members.

Transaction costs can be split into direct costs, such as dealing commission, transaction taxes and custodian fees, and indirect costs, such as the spread costs of underlying assets being bought and sold.

The disclosure of transaction costs is an area that is causing concern amongst the industry. As you can see from the graph below, 60% of IGCs in our sample were unable to obtain any information on transaction costs. As reasons for non-disclosure, IGCs cited the lack of regulatory obligation on fund managers to disclose information and the fact there is no common methodology for calculating or benchmarking transaction costs.

Only 40% of IGCs managed to obtain information on transaction costs and of these, only 10% obtained all direct costs applicable to their most popular investment funds.

30% obtained some information on transaction costs such as the range of transaction costs in certain fund ranges and the level of investment returns after the impact of all charges, including transaction costs, had been taken into account.

In general, our research shows there is a disconnect between the information IGCs are required to obtain, assess and report on, and that which fund managers are willing to provide.

Next steps for IGCs

On the whole, the IGCs in our sample have recognised the limitations of their first annual report and have already implemented a plan of action with providers to improve member outcomes going forward. Most of the IGCs have targeted a further reduction of charges and propose to review the suitability and appropriateness of their investment strategies as priorities for this year. 50% of the IGCs in our sample sought to remove early exit charges for at least a proportion of their membership and 30% sought to improve technology, such as introducing digital platforms, in a bid to increase member engagement. In general, there has been low member feedback to the annual reports which show the continued issue of member engagement and people not wanting to read pensions literature. To combat this, we are seeing IGCs planning to obtain feedback on what members value and improve the quality of their communications to drive member engagement and trust in their pension scheme.

Further scrutiny of transaction costs and benchmarking are key areas to consider but most IGCs did not include these as next steps because they recognise that progress depends on further regulation and guidance from the FCA.

As the industry awaits with baited breath, however, we are starting to see fund managers disclose information on transaction costs as they recognise that non-disclosure could potentially affect future business. This is very much an evolving area and we will be monitoring developements.

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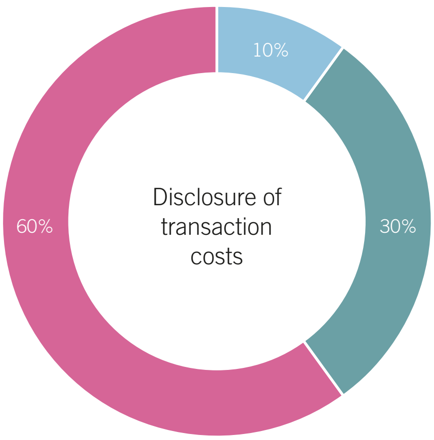
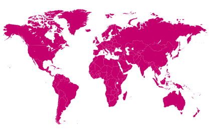


- Most direct transaction costs disclosed, but no indirect costs
- Some information on transaction costs disclosed
- No information on transaction costs disclosed

> Transaction costs are costs incurred as a result of buying, selling, lending and borrowing of investments (i.e. costs linked with investing to generate return)

> Disconnect between IGCs' requirement to obtain information on transaction costs and providers' requirement to disclose information



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