Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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This is the Financial Services Consumer Panel's response to the Financial Conduct Authority and Department for Work and Pensions joint call for evidence: *Transaction Costs Disclosure: Improving Transparency in Workplace Pensions.*

In 2014 the Panel commissioned research to examine problems of cost opacity, cost control, lack of transparency, and weak governance structures in the long-term investment market. These problems are persistent. As far back as 2002 Ron Sandler found that "the reporting of product charges is typically neither clear nor consistent" in the UK investment market. Others have found the same systematic problems, including Paul Myners, the Office of Fair Trading, the Financial Services Authority and the Kay Review of UK Equity Markets and Long Term Decision Making.

We found that:

1. The full costs of investment borne by savers are not known. Many costs are deducted from the fund and hidden from view. Costs are often not properly measured or declared and even fund managers frequently do not appear to know the total costs applied against a given fund. The explicit costs charged to the customer - including those within the annual management charge (AMC), the total expense ratio (TER) and the ongoing charge figure (OCF) – are a poor guide to the full costs.

2. Even institutional investors of large pension funds may not know the full costs of investing. It took a major study by Hymans Robertson, a pensions consultancy, to find potential for significant savings in the Local Government Pension Scheme by switching to passive investments away from generally underperforming actively managed funds.

3. The use of charge caps can have no effect unless the way costs are charged and disclosed. Cost suppression in one place has led to cost inflation in another – the so-called 'waterbed effect' – with no net impact..

4. Complex fund structures, combined with weak governance and asymmetries of information and power between the retail investor and the investment manager, have resulted in an unbalanced principal-agent

relationship. Competition cannot flourish in a market where consumers have no bargaining power.

The Panel strongly believes that these problems should be fixed, and fixed soon. Pension savers – including millions auto-enrolled into occupational pensions - depend on the fund management industry for their long-term financial wellbeing.

A disclosure regime alone will not address the deep-seated problems in this market. This is why we have called on policy makers to consider the feasibility of a single investment management charge. This would mean *all* costs, charges and expenses being borne directly by the firm and reflected in a single charge to the investor. This would include implicit costs, which the Panel has always argued are possible to estimate.

The Panel strongly supported the recent establishment of Independent Governance Committees (IGCs). We believe regulators and government should consider additional ways to strengthen governance structures to ensure these genuinely represent consumer interests and manage conflicts of interest robustly.

The effectiveness of IGCs and Trustee Boards is dependent on their ability to assess value for money. They cannot do this without access to clear and comprehensive information on costs and charges. This should be standardised so that investors or their representatives can readily compare schemes.

We also believe that these proposals should read across to Defined Benefits schemes as soon as practicable, and would urge the FCA/DWP and The Pensions Regulator to set a timescale for achieving this.

We have commented on those questions where we feel we can add some value, but we are not able to comment on some of the more technical issues. However, we do urge the FCA/DWP to use this opportunity to explore every possible method of surfacing and reporting all costs and charges that affect the return pension savers receive. Both the FCA's own recent research conducted by Novarca and the two reports commissioned by the Consumer Panel provides solutions to the assertion by the asset management industry that full cost disclosure is "too difficult".

We believe the FCA/DWP should adhere to the overarching principles in the Novarca research i.e.

1. Can the cost be measured as accurate or observed? Does a useful proxy or estimate exist?
2. Is the cost material? Does it have a significant impact on policyholder's returns?
3. Can the cost be controlled or reduced? Once the cost is transparent can it be influenced?

It is our belief that any costs or charges that fall within these three principles should be surfaced and reported to IGCs and Trustees in a format they can use.

Questions

Question 1: Should the requirements for standardised, comparable disclosure of transaction costs apply only to those schemes that will be subject to the new governance and charges measures from April 2015? If not, are there differences that should be taken into account when considering transparency in other schemes?

No. As demonstrated by the Hymans Robertson example and also the example of Railpen[1]– it is just as crucial that trustees of DB schemes have full visibility of all costs and charges.

Question 2: What are the advantages and disadvantages of capturing and reporting bid-ask spreads? Do you have any views on the ease of identifying bid-ask spreads, or modelling them? What practical challenges are there in calculating bid-ask spreads? Do you have any views on estimation models of bid-ask spreads?

A bid-ask spread can be seen and measured and is relatively easily understood. It is a good way of capturing some implicit costs.

Question 3: What are the advantages and disadvantages of capturing and reporting market impact? Do you have any views on the ease of identifying market identifying market impact costs? What practical challenges are there in calculating market impact costs? Do you have any views on the possible estimation models of market impact? Do you have any views on the availability of these models, their consistency, and the costs providers charge to access them?

Market impact is a potentially highly significant cost, particularly for relatively small schemes. Novarca has suggested there are reputable sources of estimates for these costs which could be used.

Question 4: Do you believe that missed trade "opportunity costs" and "delay costs" are transaction costs? Do you believe that there is merit in reporting them as part of the disclosure regime and in governance bodies reviewing them? Do you believe that the practical issues, for example around the subjective nature of some of the inputs needed to calculate them could be addressed?

Opportunity and delay costs can have a significant effect on returns and should be accounted for as transaction costs. These costs reinforce the case for a single charge: there is no incentive to keep them to a minimum as they are hidden from view. IGCs should, we believe, demand to know what these costs are, and if they are high compared to other, similar, funds, ask why they are higher.

[1] In August 2014 it was reported that after an 18 month investigation the Railway Pension Scheme Railpen found that headline costs were a fifth of the true costs being paid by the scheme.

Question 6: Do you have any comments about the different frameworks within which information might be reported and their respective strengths and weaknesses?

Instinctively we feel that a framework that provides IGCs with the knowledge they need to consider whether the asset management under each scheme is providing value for money must be the right one – no matter how complex this may seem initially. We cannot believe that an industry as automated as the asset management industry could not provide this information to IGCs in the format they need.

However, this is a crucial area that we think needs further work. We urge the FCA/DWP team to put together a working group consisting of both industry and consumer representatives with the requisite technical knowledge (we can make suggestions as to who these might be) to consider the pros and cons of each option. We would also suggest that the working group invites the Chairs of IGCs to give their views, based on their early experience.

Question 7: How should transaction costs incurred at product level be captured and reported? Would there be merit in splitting out costs incurred for different reasons? How could this be achieved in practice? Are there any other costs incurred at a product level that are not administration charges, and that could potentially be considered transaction costs?

This question could be considered by the working party alongside question 6 as it clearly requires considerable technical input. All transaction costs, whether incurred at product level or below should be captured and reported, but we could see the value of possibly splitting out costs such as fund switching costs.

Question 8: Do you have any views on whether pension schemes should be required to look through to the transaction costs of all listed, exchange-traded investment schemes? Do you have any particular comments on how the transaction costs incurred by property, (and other real asset investments), private equity and hedge funds should be identified and disclosed? Is separate guidance needed on how to disclose transaction costs in these areas, or can the principles used in securities markets be applied?

Given the importance Novarca places on "look-through" costs, we consider that pension schemes should be required to look through to the transaction costs of all listed exchange-traded investment schemes. It will be for the industry and other experts to consider how certain of these costs should be identified and disclosed and whether the principles used in securities markets can be applied.

Question 10: Do have any views on the different approaches to calculating transaction costs? Do you agree that a principles-based approach is appropriate to set how transaction costs should be reported for each type of asset? Do you have any comments on the reporting of negative transaction costs?

We are sceptical of the effectiveness of a principles-based approach. We can see the value of a hybrid approach as suggested by Novarca but we feel that, given the current level of opacity in costs and charges and the way the market has historically operated, the FCA/DWP should define in detail how each type of cost should be treated rather than setting out a series of principles within which firms are expected to operate. **Question 11: Should portfolio turnover rates be reported alongside transaction costs? If so, do you have any comments on the best methodology to use to ensure comparability of portfolio turnover and transaction costs?**

Yes. As DP15/2 states, the portfolio turnover rate is the most important contextual information for transaction costs and must, therefore, be reported.

Question 13: Do you have any views on the value and/or costs of benchmarking? Are there any other issues to be taken into account when exploring benchmarking?

Benchmarking is a valuable tool and should be made available to IGCs. Comparable data should be collected and published as soon as possible, by the FCA or another body independent from the industry.

Question 15: Do you have any comments on the practical issues with presenting costs and charges information? Do you have any comments on the degree of standardisation that will both enable governance bodies to take decisions on their scheme and achieve comparability across the market? Are there any other factors in the presentation of transaction costs in a report that would enable governance bodies to make better decisions?

Novarca has provided an example template for a cost report. This looks like a good starting point. IGCs must be able to benchmark against other funds or schemes, a job that will be impossible without a high degree of standardisation.

Question 16: Do you agree with the use of portfolio turnover rates and unit transaction costs to enable better prediction of likely transaction costs? Should providers be required to provide reasons if turnover rates are likely to be different in the forthcoming period? Is there any other information that would enable the governance body or scheme members to understand potential future transaction costs?

Yes. PTRs and unit transaction costs are a good contextual measure of transactions. We also agree that providers should be required to provide reasons if turnover rates are likely to be different as this might indicate a change in investment strategy. At the very least, IGCs should be given the opportunity to question why PTRs are different to those estimated.

Question 17: Do you have any comments on whether a transaction cost disclosure regime will have any other consequences for the way that pension schemes and their agents transact?

Transaction cost disclosure may well have other consequences, but this is one of the reasons we are urging the FCA/DWP to consider adopting the "single charge"

solution. If one charge only was permitted against the fund, and all other costs and charges were deducted from the asset management company then there would be little or no consequence to transaction cost disclosure – at least none that would affect pension scheme members.

Question 18: Should regulations and rules on transaction cost disclosure only directly apply to pension providers and trustees? If not, on whom would additional disclosure requirements be necessary to ensure that transaction costs are reported accurately to relevant people?

No. Regulations for transaction cost disclosure should apply to all participants in the value chain. It is pointless to have regulations applied to pension providers and trustees unless there is a guarantee that they will be able to obtain the information they need to comply with the regulations.

Question 19: What information on transaction costs would be useful to employers and members? How and when should this be reported to them?

Employers and members won't require the level of detail on costs provided to IGCs and Trustees. What they will need is information which allows them to make informed choices regarding the choice of fund(s). A single charge would be the simplest measure for employers and members to compare the total costs of one fund against another. A risk/return measure is also essential to allow members to choose fund(s) which meet their attitude and capacity for risk.

Question 20: What information on costs and charges should be made publicly available? When and how should this be information be provided?

Again, the Panel believes a simple measure of a fund's total costs and charges should be made available publicly. This could be the same measure as the one provided to employers and members. Both sets of information needs to be collected by the regulator or an independent and trusted third party. These must not be statistics produced by the industry for the industry or consumers will not trust them.

Question 21: Are there any areas that you would highlight where firms, trustees or asset managers may not comply with the disclosure regime in the way intended? If you are concerned that this may be the case, are there steps that could be taken to reduce the incentive to get around reporting transaction costs? Would third-party oversight of reports enhance their value and usefulness?

Unless a method of surfacing all costs and charges can be found fund managers can continue to 'hide' certain costs and charges by deducting these directly from the fund. Any cap on visible charges will therefore only result in an increase in hidden charges: the so-called 'waterbed effect'.

A third-party oversight of reports will be essential but we assumed this is the role the FCA and the Pensions Regulator would play.

It is essential that the rules and regulations when they are initially drawn up do not allow for any loopholes and apply to all participants in the value chain, so that ways around full disclosure cannot be found.