

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

March 2016

Discussion Paper

Investment costs and charges – where are we now?

Summary

The problems of cost opacity and conflicts of interest in the management of retail investment funds are long-standing. This is bad for investors, as small changes in costs and charges have a large impact on the size of their fund. With auto-enrolment gathering pace, and the introduction of pension freedoms in April 2015, the need to address these problems is more urgent than ever.

In 2014, the Panel recommended a single charge to retail investors, with the pricing risk borne by the asset management company. That remains our long-term goal. A year on, there is some progress towards transparency: new EU legislation will increase pressure for detailed disclosure in retail investments, and the Financial Conduct Authority (FCA) and Department for Work and Pensions (DWP) last year issued a call for evidence on transaction costs reporting in workplace pensions¹. These are welcome developments, but we wanted to see if faster progress could be made, bearing in mind the urgent need for pension savers to get a good deal.

The Panel commissioned Dr Chris Sier to undertake further research, focused on pension funds. We wanted to see to what extent costs and charges could be surfaced and disclosed, so that those responsible for assessing value for money and getting the best deal for scheme members could do their jobs effectively.

The research proposes a data standard² for pension funds and their providers. The data would be relatively easy to collect, and could be implemented through a voluntary code, compliance incentives such as kite marking (possibly enforced by regulation), or by regulation. While the standard does not cover 100% of costs, it marks a significant advance on the current position.

¹ Transaction Cost Disclosure: Improving Transparency in Workplace Pensions. FCA/DWP.
<http://www.fca.org.uk/static/documents/discussion-papers/dp15-02.pdf>

² See Annex Two of this paper for the cost collection templates.

1 Background

- 1.1 In November 2014 the Panel published *Investment Costs – more than meets the eye*³, informed by two research studies⁴ the Panel had commissioned from industry experts. These studies provided a “state of play” analysis of the extensive literature on costs and charges within the asset management industry, together with an insider’s view of the way the industry operates in practice. The main findings were:
- The full costs of investment charged to investors are simply not known – even by the asset management firms that deduct them from the fund.
 - Costs deducted from the fund directly by the provider are often not properly measured or declared.
 - Explicit costs charged to the customer through the annual management charge (AMC), the total expense ratio (TER) or the ongoing charge figure (OCF) are a poor guide to the full costs – and yet they are the only measurements available to investors and their advisers.
- 1.2 At a roundtable the Panel held in January 2015, attendees agreed that costs and charges mattered greatly to consumer outcomes. There was general consensus that the Panel’s recommendation of a ‘single charge’ to consumers was right in principle, if fraught with practical difficulties.
- 1.3 Part of the rationale for a single charge was that it would introduce the ‘right’ kind of competition into asset management. The single charge would almost definitely be considerably higher than the currently quoted AMCs, TERs or OCFs. However, it would be transparent and provide investors and their advisers with a genuine view of costs and a more meaningful method of comparison, driving competition that worked in consumers’ interests.
- 1.4 A single charge regime would also place investment managers at risk for the decisions they make and strengthen accountability, not only to the investor but also to the firms and pension schemes that employ them. Investment managers would be incentivised to look for the best deal for the myriad of services that they currently just charge to the fund, and so don’t need to think about as the investor pays.
- 1.5 Many in the industry continue to argue that a single charge is not feasible. We do not underestimate the scale of the challenge needed, but believe the barriers can be overcome, and a single charge remains our long-term goal. Meanwhile, we want to explore how full transparency of cost and charges could be achieved.

³ Financial Services Consumer Panel Discussion Paper: *Investment Costs – more than meets the eye*, November 2014.

https://www.fs-cp.org.uk/sites/default/files/investment_discussion_paper_investment_cost_and_charges.pdf

⁴ Investment Costs: An Unknown Quantity, A literature review and state of play analysis, November 2014: https://www.fs-cp.org.uk/sites/default/files/investment_david_pitt_watson_et_al_final_paper.pdf; and Collective Investment Schemes Costs and Charges: Implications for Consumers, Rajiv Jaitly November 2014: https://www.fs-cp.org.uk/sites/default/files/investment_jaitly_final_report_full_report.pdf

⁵ Minutes of the Investment Costs and Charges Roundtable hosted by the Financial Service Consumer Panel on 16 January 2015: https://www.fs-cp.org.uk/sites/default/files/roundtable_discussion_investment_charges_final_20150127.pdf

2 EU legislation

- 2.1 Recent EU initiatives have increased pressure for transparency, notably the requirement for full disclosure of costs and charges in the Markets in Financial Instruments Directive II (MiFID II) and the requirement to provide a standardised “Key Information Document” (KID) to retail investors buying Packaged Retail and Insurance-based Investment Products (PRIIPs). The KID will include comprehensive information on costs.
- 2.2. The European Commission has proposed a delay in the implementation date for MiFID II, to January 2018. Neither MiFID II or PRIIPs will apply – at least initially - to pension funds. The PRIIPs regulation will apply from December 2016 and, given that asset managers will have to report costs to PRIIPs KID standards on the underlying assets, it may be that this could read across to pension funds to a certain extent.
- 2.3 The revised Directive on Institutions for Occupational Retirement Provision (IORP II) includes measures to increase transparency for pension scheme members by requiring disclosure of the target level of benefits, risk exposure and investment management costs in a Personal Benefit Statement (PBS). Unlike the PRIIPs KID, the PBS is not harmonised. Member States will probably have to implement in 2018.
- 2.4 In the meantime, the Panel believes it is important to understand how charges are applied to pension funds. If these charges are understood by trustees and Independent Governance Committees (IGCs), this would allow them to interrogate charges and compare them across the market, thereby increasing their power to influence where currently no leverage exists. Even if this leads to small reductions in costs and charges, this will result in large reductions over time, and significant benefits for workplace scheme members.

3 Cost transparency in UK pension funds

- 3.1 The UK pension market is still undergoing significant reform, which has created an ideal opportunity to focus on transparency of costs and charges. This is a market where the potential for consumer detriment is high and where the need for transparency and clarity on the costs individuals are paying is most pressing. As an illustration, DWP has modelled the effect of different charges on an individual saving for their entire working life. This shows that their pension income would be over 25% higher if they saved into a scheme with a 0.5% charge on funds under management rather than one with a 1.5% charge.⁶ However, negotiating lower costs is impossible if the true costs are hidden from view. In 2014 Railpen Investments, a £20 billion pension scheme, investigated the fees it paid its asset managers. After many months, and with great difficulty, it found that the headline fees of around £70 million a year were in reality a fifth of the total costs. It has since undertaken a ruthless re-shaping of

⁶ DWP Impact Assessment on Charges in Qualifying Pension Schemes, February 2014: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/311363/pensions-act-ia-annex-g-charges-in-qualifying-pension-schemes.pdf

the scheme's portfolio, bringing much of the investment in-house, dramatically reducing the fees paid by the scheme, and consequently its members.^{7, 8}

- 3.2 Automatic enrolment means that an extra £11 billion a year will be put into pension savings by around six to nine million people either newly saving or saving more into a pension⁹. Yet pension scheme members have little or no control over the choice of scheme or the funds offered to them. They rely on their employer to pick a good scheme, and on Trustees or IGCs to ensure the provider is providing value for money.
- 3.3 While DWP has capped member charges at 0.75% for default funds in occupational schemes¹⁰, as the cap excludes transaction and some other costs, it is effectively meaningless if costs can be hidden elsewhere.
- 3.4 In February 2015, the FCA introduced a new requirement for IGCs for contract-based defined contribution (DC) schemes. Like trustees of trust-based DC schemes, IGCs are required to report on whether the pension schemes provide 'value for money' for the members. To fulfil this requirement, IGCs and trustees will need to obtain information about transaction costs and administration charges from those managing their scheme assets.
- 3.6 The 2015 pension reforms will result in more people leaving their pension pots invested to provide them with a flexible retirement income. To understand how much can safely be withdrawn from these invested funds to avoid the risk of running out of money in later life, it will be essential for individuals and their advisers to know the exact level of costs applied so the drag on the fund can be accurately included in the calculation.
- 3.7 The reforms have also intensified the focus on pension costs, most notably 'exit' fees. It could be argued that as pension savers become increasingly aware of fund costs – before, at and in retirement – there is a growing risk of public faith in the pensions system being further undermined by the industry's failure to ensure transparency of costs and charges.

4 Findings from recent research

- 4.1 In December 2014 the FCA published research commissioned from Novarca¹¹ to examine transaction cost transparency within Group Personal Pensions (GPPs). Key findings included:
 - The most significant transaction costs can be made transparent quickly, using good estimates or proxies for some costs.

⁷ "Investors' headline fees 'only a fifth' of total" FTfm, 24 August 2014: <http://www.ft.com/cms/s/0/0511fa7c-2a08-11e4-8139-00144feabdc0.html#axzz40FfDd649>

⁸ 5 Professional Pensions (27 August 2014), "Railpen to reduce external managers over fee concerns"

⁹ Ibid

¹⁰ Occupational Pension Schemes (Charges and Governance) Regulations 2015. The FCA also introduced equivalent rules for workplace personal pensions.

¹¹ Transaction Costs Transparency, Novarca, November 2014: <https://www.fca.org.uk/your-fca/documents/research/transaction-costs-transparency>

- There are technical challenges to collecting data at the scheme level, but data are available at the portfolio level.
- GPP providers have asked for common standards for measuring and reporting costs. This would encourage market participants to provide information and make industry benchmarking possible.
- The absolute level of costs does not tell the whole story about value for money. The degree of portfolio turnover and the underlying investment strategy should be taken into account.
- The Netherlands provides an example of the benefits of introducing simplified transaction cost reporting.

This research, for the first time, exploded many of the myths about the difficulty of achieving more transparency in reporting costs and charges.

- 4.2 The recent research commissioned by the Panel looks at how far cost transparency can go, based on international experience and what is practically achievable now in the UK. The author proposes a new standard for data collection on costs and charges, designed to collect data that is currently available but rarely made available to savers or their representatives. The research paper explains how this new standard could work in practice and provides case studies, including one of a leading UK active equity asset manager that was able to provide all the information needed in a clear and concise format. The asset manager understood that its transparency could enable it to gain significant competitive advantage.
- 4.3 The template does not surface 100 per cent of all costs charged. However, it would be an improvement on where we are now. More importantly, pension funds could start to apply the standard immediately, as the data it requires are already both available and accessible. This would enable those charged with protecting pension scheme members' interests to begin to ask the right questions, and negotiate cost reductions.
- 4.4 Although at least one asset manager has shown that costs and charges can be surfaced, the research indicates that many are likely to be unwilling – or even unable – to comply with a standard. Pension schemes do not necessarily have the expertise or teeth to demand the right information or apply sanctions when they don't get it.

5 Conclusions and recommendations

- 5.1 European legislation will go a long way towards surfacing asset management costs and charges. However, implementation of MiFID II may now be pushed to 2018 given the European Commission's proposal for a delay and there are clear challenges still to be overcome with implementing the exacting requirements of the PRIIPs legislation.
- 5.2 It is imperative there is improved transparency of costs and charges in pension funds held in UK pension schemes. Trustees and IGCs must have clearer sight of the charges they are paying so that they can secure savings for their members. Improvements could be brought about simply by compelling asset managers to supply the information they should already be supplying to pension scheme governors.

- 5.3 Exposing previously hidden costs and charges will not, of itself, tackle the conflicts of interest inherent in the asset management industry. That requires structural change. The FCA is currently undertaking a market study of the asset management industry, which should expose these conflicts and propose solutions.
- 5.4 There is support for a single charge regime, but the practical barriers need to be overcome.
- 5.5 The Panel therefore **recommends** that:
- The FCA, DWP and TPR, along with the relevant professional and trade bodies, should define and implement a standard for collection of costs and charges, as set out in the accompanying research paper: *The Drive towards Cost Transparency in UK Pension Funds*¹².
 - The standard should initially be based on data that asset managers can report immediately. It should be consistent with the PRIIPs definitions of costs, and the outcome of the DWP/FCA work on transaction costs.
 - Data collection should be in a standard format, and reported on a “comply or explain” basis.
 - The FCA and TPR should strongly encourage IGCs and Trustee Boards to use only pension funds that comply with the standard.
 - The FCA should conduct research into the practical difficulties of a single charge, and make proposal for overcoming these.

¹² Further details can be found in the research accompanying this discussion paper: *The Drive Towards Cost Transparency in UK Pension Funds*, Dr Christopher Sier FRSA, 2016

Annex One - Key findings of the studies from November 2014

Investment Costs: An Unknown Quantity, A literature review and state of play analysis, November 2014¹³:

1. Costs make a very significant difference to investment outcomes;
2. It is not possible from the literature to know with any accuracy, the costs borne by the saver;
3. This is because many costs are not declared to the saver; implicitly and explicitly they are deducted from the savings account without the customer's knowledge. Indeed, implicit costs (such as trading spreads) may not even be known by the fund manager;
4. Even where costs are declared, they are ill understood;
5. Costs of at least some products, or ranges of products seem very high;
6. There do appear to be good products on the market, but that the price of similar products varies very significantly, perhaps by as much as four or five fold, for near identical services. Such price differentials are incompatible with the operation of efficient markets where such anomalies would rapidly be competed away.

Any solution as to how consumers might be better served in accessing effective low cost savings and pension products must begin with an understanding of the difficulties in discovering costs as many charges are simply not declared, and may not even be collected, customers of investment products are often unaware of charges or of their significance to outcomes and for many investment products, for good reason, it may not be the saver who negotiates the contract with the service provider. There are also methodological difficulties associated with the bundling of services. So, for example, the management of a pension may bundle investment management and other administrative tasks.

In general, the market for investment products and services is characterised by a high degree of 'asymmetric information'. That is, that the customer may find it difficult to judge, (even after the service has been delivered), whether or not the work was done well, and value was achieved for the money spent. One might compare it to the situation with someone buying complex medical care. It is also characterised by a very complex 'value chain', where each participant has a different way of seeking payment. It is to this situation that the opacity of fund charges is introduced, making it difficult to ensure that savers get value for money.

Nevertheless, despite the fact that we cannot give a definitive view on the cost of investment, there are some important conclusions which the authors of this report would suggest can be drawn. These include: -

1. That costs should be understood and reported:
 - a. Since costs are important to investment outcomes, they must surely be managed, and so need to be known by those commissioning them. The literature (for example Lane Clark Peacock 2013), and our own experience both as fund managers, and in managing the information systems of fund management houses, suggests that many investment managers are themselves unaware of the costs, (particularly the implicit or hidden costs) to which they are committing

¹³ A summary of Investment Costs: An Unknown Quantity, A literature review and state of play analysis, A report for the Financial Services Consumer Panel, David Pitt-Watson, Shyam Moorjani, Dr Chris Sier and Dr Hari Mann, November 2014:
https://www.fs-cp.org.uk/sites/default/files/investment_david_pitt_watson_et_al_final_paper.pdf

client money. It can surely be argued that this failure is not compatible with the duty owed to clients. Thus, as a precursor to any further reform investment managers might be required to calculate and collate the costs which they are commissioning on others' behalf, particularly all cash costs.

b. Our literature search has not been successful in discovering the true cost of investment. Yet those costs are critical for outcomes and studies suggest that actual costs could easily be double the stated Annual Management Charge, or similar figure of which consumers are made most aware. (Edelman et al., 2013, Bogle 2014, Frontier Investment Management 2007). If the financial services industry is to give best outcomes, we would suggest that all those who can help manage these costs, should know what they are, and hence be able to judge their value.

c. In particular this should involve ensuring that customers receive comprehensive information and estimates of the total costs that will be incurred both before, and during the period over which funds are managed. That information should be presented in a form which is readily understood, particularly as regards its effects on investment outcomes. (RSA 2012, Turner et al., 2008).

2. That customers be informed, and even guided toward best buy alternatives:

a. The literature suggests that, if customers were to purchase at lowest cost, this could dramatically improve long term outcomes. However, we should not exaggerate the ease with which customers will be able to distinguish between good and bad products. One way in which this might be better achieved, would be to create simple categories of product, which assist consumer choice.

b. It might also be worth considering whether as in medicine, certain low cost, well-regulated products could be sold over the counter, whereas more complex or expensive products, or ones where the consumer was particularly vulnerable would require the advisor to accept liability for their appropriateness. So, for example, default workplace pensions are to have fees capped, but this will not apply where the saver makes a specific choice. (See arguments made in Pensions Institute/Harrison et al., 2012).

c. Ultimately fee capping of the full costs (TER plus other implicit and explicit costs) may be an option, and indeed given the lack of consumer knowledge may be necessary, particularly for situations where the consumer has little control or understanding of the purchase decision.

3. That governance rules be strengthened:

a. Two other approaches which directly address the problem of asymmetric information are worth noting: The first approach is to place the supplier under a fiduciary duty (accountable under law and regulation) to act in the interest of the customer.

b. The second approach is to ensure that, where transactions take place from a seller with deep knowledge, that an intermediary is found who will act in the interest of the actual investor. It is this logic that lies behind the use of Independent Financial Advisers (IFA's) in the UK. However, no fiduciary can be allowed to profit at the expense of those they are there to serve.

4. That appropriate institutional arrangements be encouraged:

a. The countries that appear to have the best quality investment and saving products have institutions which are likely to create such outcomes; they are likely to be of scale, and low cost. They are likely to have fiduciary management. The influence of Vanguard, the low cost mutual savings vehicle in the US, or the structure of the collective pension system in Holland would be cases in point. Scale economies also help reduce costs (Bikker 2013). Policy makers might

reflect on how the features that underpin such institutions can be nurtured in the UK.

Collective Investment Schemes Costs and Charges: Implications for Consumers, Rajiv Jaitly November 2014:

1. Consumers continue to suffer detriment 17 years after problems were first highlighted

Investment funds are a vital form of savings for consumers that enable them to achieve their long-term goals. Yet, the most recent OFT report shows that the causes of consumer detriment in DC pension schemes, in relation to costs and charges, continue to persist since the first time they looked at the subject almost 17 years ago, which suggests that radical intervention is required.

Investment management, like any other business, is driven by profit motives. But profit maximisation predicated on an ability not to have to disclose all investors' costs and evidence of poor management of conflicts of interests, skews the basis on which healthy competition depends.

2. Fund structures are complex and not well understood, leading to a lottery of outcomes for consumers

Fund structures are highly complex.

This complexity is frequently driven by regulatory and tax requirements, rather than by how investment managers actually manage funds in practice. Differences in fund structures can create a lottery of outcomes for retail investors in terms of costs, risks and protection.

Differentiation between retail and institutional investors (required by regulation) can create further complexities such as through the types of structures used and even the creation of 'share classes' within a structure to accommodate different types of investors with different terms. These differences between retail and institutional investor can often be cosmetic and do not necessarily reflect how investments in a fund are actually managed. This can create hidden risks for retail investors, who can also pay much higher charges than their institutional counterparts. Moreover, retail investors, unlike institutional investors, have little bargaining power over the terms of investment and are not in a position to influence or challenge investment managers' decisions.

3. Weak fund governance and poor conflict of interest management does not work in the interests of consumers

The governance of investment funds can often be weak and conflicted, especially in 'vertically integrated' financial services businesses, where affiliated companies control and manage multiple stages in the 'value chain', including investment management, brokerage and the administration at 'product' or wrapper level, e.g. in a DC pension scheme or ISA.

Weak governance also affects performance because it can be difficult to replace an under-performing investment manager. This can be due to the structure of commercial arrangements or through the operation of conflicts of interest because the manager effectively chooses those responsible for governance – a problem that can exist even when governors are supposed to be independent.

4. Incomplete disclosures on costs and charges makes comparability and good decision making difficult

Regulatory requirements on disclosure continue to omit full disclosure on all costs such as transaction costs. Transaction costs can form a significant proportion of the costs investors bear. In the absence of full information on all costs it is difficult to compare investments and make investment judgements.

5. Fiduciary duties of investment managers to protect consumers are usually an illusion

Due to the complexity of investment products, full transparency and disclosure on their own are unlikely to ever be enough to protect retail investors in the absence of strong independent governance and greater duties for service providers.

Service providers do not usually have a fiduciary duty to act in the best interests of customers. Fiduciary duties do exist in the governance of investment funds but can be conflicted and therefore devoid of adequate challenge. Consumers sometimes refer to UK investment managers having a fiduciary duty, but this is usually not the case. The regulatory requirement for firms to 'treat customers fairly' (TCF) is not synonymous with fiduciary duty.

6. Economies of scale tend to benefit the investment business more than the consumer

'Integrated' or affiliated business models can lead to significant economies of scale. However, it is not a given that these savings are passed on to retail investors in the form of lower costs and charges.

7. Performance reporting can be very misleading

The reporting of performance – the main metric on which investment managers compete – can be very misleading. Investment managers can disguise investment losses when they close and merge poor-performing funds and transfer the assets to a new fund. This creates significant distortions ('survivorship biases') in the way performance is reported, which can serve to suppress the poor performance of the original fund in which the consumer invested.

Moreover, reporting on fund performance, and the provision of information for investors appears to be driven primarily by the technical and operational requirements of regulators and providers rather than the needs of retail customers and can be very confusing.

8. Consumers have insufficient power to look after their own interests

Asymmetry of information in the principal-agent relationship between investors and managers allows investment managers to exploit retail investor behavioural biases, such as investor inertia. Investment fund boards may not be able to remove or replace an investment manager. Moreover, even where investors do successfully sue a manager, they may still have to pay for the manager's defence. There are therefore significant problems with the way contractual arrangements on funds can be structured.

9. Consumer protection lacks clarity and certainty

No compensation may be available on some investment products, depending on how the investment is made, or may be severely limited, depending on the investment structure chosen. The arrangements are complicated, lack clarity and can have uncertain outcomes. Current consumer legislation on unfair contract terms is weak in relation to challenging insurance contracts (which include 'unit-linked' funds) and securities transactions. Consolidation and updating of this legislation is currently underway but

appears to continue to exclude insurance contracts. The regulators also have limited powers under these laws.

10. Regulatory arbitrage is possible to manage risks

There are too many regulators and ombudsmen with differences in the powers and functions they have over investment products and wrappers. This can lead to the risk of regulatory arbitrage if providers choose structures where there may be an assumption of a 'lighter touch' regulatory regime whether in relation to governance or costs which may reduce the risks of sanctions if things go wrong. Regulatory arbitrage is likely to benefit investment managers and product providers rather than consumers.

Annex Two: Cost Collection Templates¹⁴

Collection template for Pension Fund Administration costs

Pension Scheme Costs								
Scheme Administrative Expenses (Pension Management)	£	Bps	Investment Management Expenses (Asset Management)	£	Bps	Total	£ / %	Bps
Total			Total			Total Scheme Costs		
Advisory fees			Fund Administration			Total Scheme Returns ??		
Actuarial fees			Administration and processing			Opening Scheme Net Assets		
Administration and processing			Employee costs			Closing Scheme Net Assets		
Bank Charges			Engagement and voting fees			Active Scheme Members		
Employee costs			Fund Accounting			Deferred Scheme Members		
Office costs			Office costs			Pensioners		
Pension payroll costs			System costs			Total Membership		
Printing and publications (Communications)			Sundry costs					
System costs			Audit					
Audit fees			Legal fees					
Legal fees			Sundry costs					
Pension Fund Committee / Board costs			Investment Management					
Pension Protection Fund Levy			Fiduciary Management					
Regulatory costs			Internal Fund Manager Base Fees					
Trustee Expenses			Internal Fund Manager Performance Fees					
			External Fund Manager Base Fees					
			External Fund Manager Performance Fees					
			Investment Consultancy fees					
			Property operational costs					
			Transaction costs					
			Other Investment Management fees					
			Custody					
			Advisory					
			Performance and Risk Measurement Services					

¹⁴ Further details can be found in the research accompanying this discussion paper: The Drive Towards Cost Transparency in UK Pension Funds, Dr Christopher Sier FRSA, 2016

Collection template for Custody costs

Total Custody		
	£	Bps
Total Cost		
Fixed		
Performance		
Transaction		
Other		
Total Income		
Investment Income		
Interest from fixed interest securities		
Dividend from equities		
Income from index linked securities		
income from pooled investment vehicles		
Interest on cash deposits		
Other - Stock lending		

Custody Cost by Asset Manager					
	Fixed	Performance	Transaction	Other	Total
Asset Manager 1					
Asset Manager 2					
Asset Manager 3					
Asset Manager 4					
Asset Manager 5					
Asset Manager 6					
Asset Manager 7					
Asset Manager 8					
Asset Manager 9					
Asset Manager 10					
Asset Manager 11					
Asset Manager 12					
Asset Manager 13					
Asset Manager 14					
Asset Manager 15					