Department for Work & Pensions

FCA
FINANCIAL CONDUCT AUTHORITY

# Transaction Costs Disclosure: Improving Transparency in Workplace Pensions

Call for Evidence

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March 2015

DP15/2

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# Introduction

This call for evidence is a joint publication between the Department for Work and Pensions (DWP) and the Financial Conduct Authority (FCA).

# About this call for evidence

## Who this call for evidence is aimed at

The DWP and the FCA welcome comments from those involved in designing and running pension schemes, managing investments used by pension schemes, pension industry professionals and advisers, pension scheme members, consumer groups and member representative organisations, and anyone with an interest in pensions.

## Scope of call for evidence

This call for evidence applies to England, Wales, Scotland and Northern Ireland.

## Duration of the call for evidence

The DWP and the FCA are asking for comments on this call for evidence by 4 May 2015. Please ensure your response reaches us by that date as any replies received after this may not be taken into account.

## Consultation principles

This call for evidence is being conducted in line with the Government's Consultation Principles, which were introduced on 17 July 2012, and have been recently updated.

The revised Principles are at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/255180/Consultation-Principles-Oct-2013.pdf

The key principles are:

- departments will follow a range of timescales rather than defaulting to a 12-week period, particularly where extensive engagement has occurred before;
- departments will need to give more thought to how they engage with and consult with those who are affected;
- consultation should be 'digital by default', but other forms should be used where these are needed to reach the groups affected by a policy; and
- the principles of the Compact between government and the voluntary and community sector will continue to be respected.

## How to respond to this call for evidence

When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents, and where applicable, how the views of members were assembled. DWP and the FCA will acknowledge your response. As this is a joint call for evidence, please send a copy of your responses to **both** of the following organisations:

**Department for Work and Pensions**

Please send your responses to this call for evidence and any queries to:

Email: reinvigorating.pensions@dwp.gsi.gov.uk

**Transparency Team**

**Department for Work and Pensions**

**3rd Floor West, Zone G**

**Quarry House**

**Leeds, LS2 7UA**

**Financial Conduct Authority**

You can send them to the FCA using the form on our website at:
http://www.fca.org.uk/your-fca/documents/discussion-papers/dp15-02-response-form

Or in writing to:

Carol McGinley or Michael Collins
Strategy & Competition
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Email: dp15-02@fca.org.uk

Please note, the Financial Services and Markets Act (Disclosure of Confidential Information) Regulations 2001 includes gateways which permit the disclosure of confidential information by the FCA to the DWP and/or by the DWP to the FCA (i) to discharge their public functions and (ii) for the purpose of enabling or assisting the DWP/FCA from discharging any of their public functions.

# Freedom of information

**Department for Work and Pensions**

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact the Central Freedom of Information Team:
Email: freedom-of-information-request@dwp.gsi.gov.uk

The Central Freedom of Information team cannot advise on specific consultation exercises, only on Freedom of Information issues. Read more information about the Freedom of Information Act[1].

### Financial Conduct Authority

The FCA makes all responses to formal consultation available for public inspection unless the respondent requests otherwise. The FCA will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, the FCA may be asked to disclose a confidential response under the Freedom of Information Act 2000. The FCA may consult you if we receive such a request. Any decision the FCA makes not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

## Feedback on the call for evidence

We value your feedback on how well we consult or seek evidence. If you have any comments on the process of this call for evidence (as opposed to the issues raised), please contact the DWP Consultation Coordinator:

Elias Koufou

DWP Consultation Coordinator
2nd Floor
Caxton House
Tothill Street
London
SW1H 9NA

Email: caxtonhouse.legislation@dwp.gsi.gov.uk

[1] https://www.gov.uk/make-a-freedom-of-information-request

Please also make any suggestions as to how the process could be improved further.

If you have any requirements that we need to meet to enable you to comment, please let us know.

# Abbreviations used in this document

| Acronym | Description |
|---|---|
| DB | Defined Benefit |
| DC | Defined Contribution |
| DWP | Department for Work & Pensions |
| EIOPA | European Insurance & Occupational Pensions Authority |
| ESAs | European Supervisory Authorities |
| ESMA | European Securities and Markets Authority |
| ETF | Exchange Traded Funds |
| FCA | Financial Conduct Authority |
| GPP | Group Personal Pension |
| HMT | Her Majesty's Treasury |
| IGC | Independent Governance Committee |
| KID | Key Information Document |
| MiFID | Markets in Financial Instruments Directive |
| OFT | Office of Fair Trading |
| PRIIPs | Packaged Retail and Insurance based Investment Products |
| PS | Policy Statement |
| SORP | Statement of Recommended Practices |
| TPR | The Pensions Regulator |
| UCITS | Undertakings in Collective Investments & Transferrable Securities |

# 1 Overview

## Introduction

1. The introduction of automatic enrolment means that millions more people will be newly saving, or saving more, into a workplace pension. Against this backdrop, Government and regulators want to work with the pensions industry to build a pensions system that people can save into with confidence, with strong governance and safeguards against high and unfair charges.
2. Transaction costs and administration charges both impact the size of a saver's pension savings. As part of this programme to strengthen workplace pensions, the Government and the Financial Conduct Authority (FCA) are committed to introducing transparency of costs and charges in pension schemes. This will be undertaken in two phases – the first phase, from April 2015, will require trustees and Independent Governance Committees (IGCs) to prepare an annual report about their scheme, including information about transaction costs as well as administration charges. To fulfil this requirement, IGCs and trustees will need to obtain information about transaction costs from those managing their scheme's assets and investments. While IGCs and trustees are encouraged to report this information in as full and useful a way as possible, there is flexibility in this first phase for governance bodies to choose how best to do this, based on the needs of their scheme and the information they have obtained.
3. The second phase will build on these reporting requirements to require disclosure of information about transaction costs and administration charges in a standardised, comparable format. The Government's commitment to requiring greater disclosure of transaction costs is reinforced by Section 44 of the Pensions Act 2014, which places a duty on the FCA and the Department for Work and Pensions (DWP) to require disclosure of some or all transaction cost information in workplace pension schemes to members, or other prescribed persons.
4. Whilst the next stage of improved transparency will cover both administration charges and transaction costs, it is recognised that administration charges, subject to the charge cap from April 2015 for default funds, are more readily identifiable and disclosed. This call for evidence therefore focuses on the identification and reporting of transaction costs information.
5. This is a joint call for evidence between the FCA and DWP to explore:
    - what costs should be included in the transaction cost reporting;
    - how such costs should be captured and reported;
    - whether information about other factors that impact on investment return should also be provided;

- how IGCs and trustees will receive costs information and whether additional disclosure requirements on other parties are necessary to enable this;
- when, how and in what format members and/or other prescribed persons should receive transaction cost information.

6. A joint call for evidence between the FCA and DWP facilitates the alignment of future disclosure rules and regulations to ensure equivalent expectations for occupational and workplace personal pension schemes.
7. In this paper, a pension scheme is:
   - for an occupational scheme, a scheme provided by a board of trustees, or by a manager, for one or more employers;
   - for a workplace personal pension scheme, a personal pension scheme or stakeholder pension scheme which employers either use for automatic enrolment or make available to their employees.
8. In this paper, a member is an individual enrolled in either an occupational or workplace personal pension.

# Who does this document affect?

9. The call for evidence will interest:
   - firms, trustees and managers operating workplace personal and occupational pension schemes which include schemes which employers either use for automatic enrolment or otherwise make available to their employees;
   - firms, trustees and managers that operate workplace pension schemes that are no longer being actively marketed to employers;
   - asset managers and other third parties providing services to firms operating workplace pension schemes;
   - IGCs who oversee work based personal pensions schemes;
   - employers and their advisers in relation to the selection and ongoing monitoring of workplace pension schemes;
   - any participant in the value chain of workplace pensions.

# Is this of interest to consumers?

10. Members of workplace pensions are different from other consumers in that they are unlikely to have made an active choice about the scheme they are saving into. Increasing the transparency of transaction costs is intended to work in the interest of relevant scheme members by enabling trustees and IGCs to have better knowledge of the costs incurred in their schemes and to be better able to compare costs. This should enable trustees to better act in the interest of scheme members and IGCs to offer credible and effective challenge to providers on the value for money of their pension schemes.

11. This paper is primarily interested in how cost information could be usefully presented to trustees of occupational pension schemes and IGCs overseeing workplace personal pension schemes. However, chapter 5 explores if providers or IGCs and trustees should report transaction cost information to employers and how and when they should report to scheme members. This chapter will be particularly relevant to consumers as it considers how and when they will receive information about transaction costs.

# Context

12. The UK has an ageing population, with many people not saving enough for their retirement. Automatic enrolment of employees into workplace pension schemes began in October 2012, as part of the Government's response to this challenge. By 2018, when roll-out of automatic enrolment will be complete, it is estimated that between eight and nine million people will be newly saving, or saving more, in a workplace pension scheme.  Many of these will be on low incomes and will not have made any active choice about how their pension savings are invested.

13. The introduction of automatic enrolment means that it is important to ensure that workplace pension schemes deliver the best possible value for money. However, the 2013 defined contribution workplace pension market study by the Office of Fair Trading (OFT)[2] highlighted problems with the existing market, including poor outcomes for the buyer and the potential for conflicts of interest. The study covered both occupational and workplace personal pension schemes, since employers can choose either type of scheme for their employees.

14. In its report, the OFT found that the market for buyers was 'one of the weakest that the OFT has analysed in recent years'. Employers make most of the key decisions but may lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term. Employees often take little interest in their pension savings and, with automatic enrolment, they make no active choice to join, are enrolled at a default contribution level, and do not need

[2] http://webarchive.nationalarchives.gov.uk/20131101164215/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505

to choose the fund into which they save. The OFT concluded that neither employers nor employees can be expected to drive effective competition between firms. However, well-governed schemes are more likely to provide value for money by reviewing the quality of scheme administration, investment management services, and costs and charges on an ongoing basis.

15. As a result of the OFT report, the DWP and the FCA, along with The Pensions Regulator (TPR), have been working together to design a package of reforms for implementation from 6 April 2015 that will help ensure that all workplace pension schemes are well run and offer value for money. The proposed FCA and DWP rules and regulations are being aligned to ensure equivalent expectations for workplace personal pension schemes and occupational schemes.

16. These measures[3] will require providers of workplace personal pension schemes to:

    - set up and maintain IGCs who will act in the interests of scheme members, operate independently of the firm and will assess, and where necessary, raise concerns about the value for money of the workplace pension schemes[4];
    - implement a charge cap on default funds offering money purchase benefits which are used for automatic enrolment in workplace personal pensions to protect members from high charges; and
    - abolish consultancy charges in schemes used for automatic enrolment.

17. The measures will also require IGCs to annually report on the value for money delivered by the schemes, including standards of administration, information about member borne deductions relating to the scheme, investment administrative costs, and transaction costs associated with buying and selling investments held within pension scheme wrappers.

18. The corresponding measures[5] for occupational schemes will require trustees, and where appropriate managers, to:

    - appoint a chair of trustees, responsible for signing off an annual statement on the value for money delivered by the scheme, including standards of administration, information about member borne deductions relating to the scheme, investment administrative costs, and transaction costs associated with buying and selling investments held within pension scheme wrappers;

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[3] FCA rules were published on 4 February 2015, and will come into force on 6 April 2015

[4] FCA final rules: http://www.fca.org.uk/news/ps15-03-final-rules-for-independent-governance-committees

[5] DWP draft regulations were published on 4 February 2015, and, subject to Parliamentary approval, will come into force on 6 April 2015

- implement a charge cap on default funds offering money purchase benefits in occupational schemes which are used for automatic enrolment to protect members from high charges; and
- in the case of multi-employer occupational schemes, meet new requirements about independent governance of the scheme, including appointing a minimum number of trustees, including those independent of providers of services to the scheme.

19. These new standards will require governance bodies to report on transaction costs for the first time. Building on this, the Government and regulators intend to introduce standardised disclosure of all costs and charges across all workplace schemes.
20. This publication is concerned with how this could be achieved to ensure that trustees and IGCs have all the cost information they need, in a format that helps them to assess value for money for scheme members.

### Wider reforms to increase transparency of transaction costs

21. Work to increase transparency of transaction costs in the workplace pensions market should be viewed in the wider context of efforts to ensure other consumers are fully informed about all costs and charges associated with other retail investments. Efforts at European Union level are already moving towards including transaction costs in any pre-contractual cost figure disclosed to the end consumer for retail investment products. This is being developed through the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation and the recast Markets in Financial Instruments Directive (MiFID II). Neither PRIIPs nor MiFID apply to workplace pensions, whether occupational pensions or workplace personal pensions, but it is important to work towards achieving consistency across the information consumers will receive in relation to these other retail investments. Negotiations also continue on European Commission governance and transparency proposals within a recast directive on Institutions for Occupational Retirement Provision (IORP II).

## An overview of the call for evidence

22. This call for evidence is split into sections as follows:
    - Chapter 2 describes the workplace pension market and explores some recent third-party reports which add to the discussion about the disclosure of transaction costs.
    - Chapter 3 analyses how transactions are made and explores and identifies the explicit and implicit transaction costs incurred by pension schemes.

- Chapter 4 reflects on the practical issues that may exist around delivering consistent disclosure of transaction costs and seeks feedback on how costs should be captured, what other information should be provided alongside transaction costs, and how the disclosure regime might work in practice, including the frameworks within which information might be reported.
- Chapter 5 considers a broad range of issues, including how trustees and Independent Governance Committees will obtain transaction cost information, whether employers should also receive such cost information, when and how scheme members should receive such information and how such information should be made publicly available. Finally this chapter explores wider governance requirements in relation to investment information.

# Next steps

## What do you need to do next?

23. Responses to the questions set out in this call for evidence and summarised in Annex 1 are welcomed. Please send your comments to both the DWP and the FCA using the details on page 4 by 4 May 2015.

## What will the FCA & DWP do?

24. . The FCA and DWP will carefully consider all comments received and use these to inform the development of proposed rules and regulations

25. The FCA and DWP intend to proactively engage with key stakeholders during the call for evidence.

# 2 The workplace pensions market

## Background

1. In the DWP 'Better Workplace Pensions' Command Paper publications in March 2014, October 2014 and February 2015, the Government outlined a vision for workplace pension schemes that will involve transparency of costs and charges throughout the value chain. Because of the impact of transaction costs on the returns delivered to investors, it is important that all costs and charges are identified and quantified so the full costs of investment services can be made clear. Taken in conjunction with new expectations about how schemes are governed, this transparency will enable IGCs and trustees to act in members' interests by understanding the value delivered by their schemes and comparing value across the market.
2. The focus of this call for evidence is to explore and identify different categories of transaction costs, how they should be captured and calculated, and what other information should be provided alongside transaction costs to help trustees and IGCs assess value for money. This call for evidence also considers how and in what format this information should be provided to IGCs and trustees, and in turn, how trustees and IGCs could disclose transaction cost information to scheme members and employers. If pension scheme operators are not aware of all the costs, including transaction costs, it will be necessary for them to obtain the information from the other suppliers in the value chain for the assets in which pension scheme monies are invested.
3. The Pensions Act 2014 places a duty on the FCA and DWP to require the disclosure and publication of transaction cost information and administration charges. The FCA will be responsible for the rules to implement these measures for the firms that it regulates and the DWP will be responsible for regulations in respect of occupational schemes.
4. Transaction costs are defined in DWP draft regulations and FCA published rules as the costs and charges incurred as a result of the buying, selling, lending or borrowing of investments. This definition provides a high-level outline of the situations when transaction costs will be incurred.
5. However this definition has primarily been constructed in order to classify those types of costs that are excluded from the charge cap in default funds of schemes used for automatic enrolment.
6. Some transaction costs are direct and visible, whereas others are harder to see, but nevertheless impact the investment return on a scheme. Some transaction costs clearly benefit someone else involved in the transaction, whereas others do

not necessarily do so, although again they impact returns. These issues are explored in Chapters 3 where feedback is sought.

7. The Government has committed to a review of the default fund charge cap in 2017, including the level of the cap and whether it should include some or all transaction costs. Greater transparency of transaction costs will help facilitate this review.

## Third-party reports

8. This call for evidence recognises and builds on work being led by stakeholders to improve transparency of transaction-related costs and charges in the investment market.

9. The Investment Association has revised its Statement of Recommended Practice (SORP) which will require managers of UK authorised collective investment schemes to provide a new comparative table in the annual report and accounts of each fund from January 2016. This summarises (amongst other items) operating charges and direct transaction costs. The Investment Association has also recently published a technical position paper[6] where it proposes eight principles that should apply to all investment products distributed to the UK retail and pensions market. These state that:

   - charges paid to an agent who invests money on behalf of a client should be expressed and calculated in a consistent manner;
   - the charges figures should be distinguishable from transaction costs, recognising the need to be able to compare fees between managers;
   - transaction costs should be disclosed to help clients – whether retail, institutional or other – understand the economic experience of monies invested in a given market on their behalf;
   - the distinction between forward-looking and historic disclosures should be recognised. While estimates can be used for point of sale documents, only historic disclosure provides full accountability;
   - the distinction between quantifiable explicit costs and indicative implicit costs, which can only be estimated, should be recognised;
   - standardised charge and cost disclosure requirements should deal only with tangible costs arising due to actual events. Intangible opportunity costs such as market impact should not be part of such requirements and can be looked at separately;
   - a calculation of total quantum of transaction costs can tell you little about how well or how badly a manager is trading within a given market. Different forms of quantitative assessment exist and may be needed by some clients;

[6] http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

- data is not the same thing as information and narrative should be used as needed to provide additional information about any of the quantitative information disclosed.

10. In November 2014, the Financial Services Consumer Panel published a discussion paper looking at costs and charges associated with investment schemes and outlined a number of possible options for reform. This paper was informed by two studies[7] commissioned by the Panel to help it better understand how the industry works in practice, the nature of fund charges and costs and the issues with the current regulatory system.

11. The Panel's report recognises that efforts to increase transparency of transaction costs may add to the pricing pressure on asset managers. However, it also recommends that a number of structural changes should be considered including:

    - mandating a single investment charge which would include all types of costs including transaction costs;
    - strengthening accountability and stewardship for asset managers as well as existing fund governance structures;
    - the possibility for consumers to track their original investment through fund closures and mergers;
    - the FCA to require fund managers to justify that their management of index constituents was active management rather than closet index tracking.

12. A number of these recommendations, particularly the latter three, go beyond the scope of this call for evidence. The FCA is therefore separately considering these proposals.

13. These reports are welcome additions to the discussion, setting out the ambition to ensure the industry is focused on the best outcomes for consumers.

14. To inform the work in this area, the FCA also commissioned Novarca to undertake research examining the transaction costs in the workplace personal pensions market. This research sought to:

    - identify the various transaction-related costs that exist within the Group Personal Pensions market;
    - determine which transaction costs are relevant to assessing the value for money offered by a workplace personal pension;
    - recommend practical methods for measuring these transaction costs;
    - propose standards for disclosing cost information so that IGCs (and trustees) can make value for money assessments.

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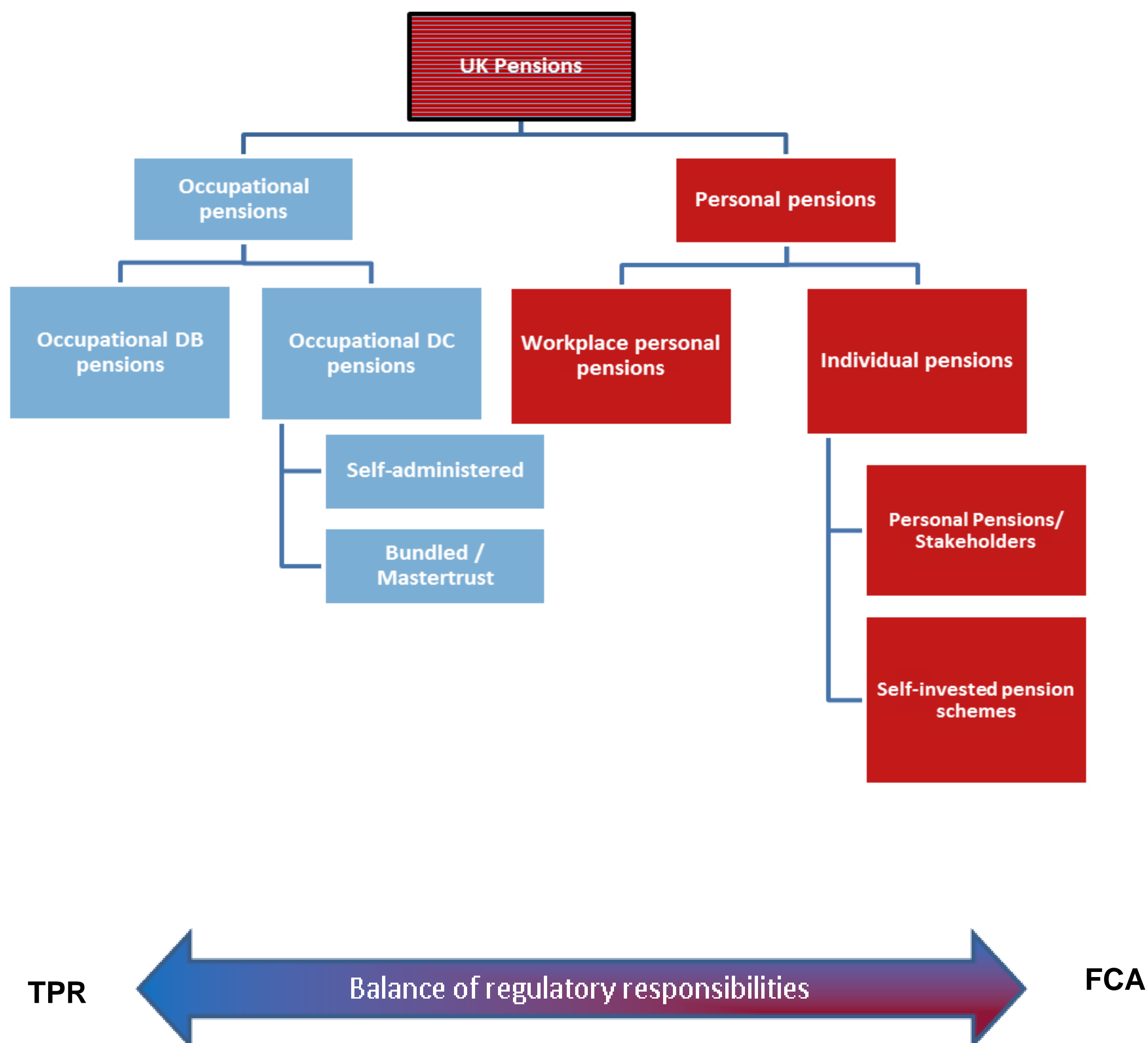
[7] Jaitly, R. (November 2014), 'Collective Investment Schemes – Costs and Charges. Implications for consumers' http://www.fs-cp.org.uk/publications/pdf/investment_jaitly_final_%20report_full_report.pdf; Pitt-Watson, D., C. Sier, S. Moorjani and H. Mann (November 2014), 'Investment costs: An unknown quantity. A literature review and state of play analysis' http://www.fs-cp.org.uk/publications/pdf/investment_%20david_pitt_%20watson_et_al_final_paper.pdf.

15. A copy of Novarca's research has been published[8] alongside this call for evidence and its findings are considered in more detail in Chapters 3 and 4 of this call for evidence. The Novarca report sets out one potential framework for capturing and reporting transaction costs and is a helpful contribution to the questions considered in this paper.

16. Chart 1 below illustrates the different types of pension arrangement within the UK market.

Chart 1: UK pension market




17. FCA product sales data from 2013 shows 21 pension providers, or groups of pension providers, set up workplace personal pensions in the UK in that year.

[8] Transaction Costs Transparency, Prepared for the FCA by Novarca International Ltd., December 2014 [hereafter referred to in footnotes as 'Novarca report'] http://www.fca.org.uk/your-fca/documents/research/transaction-costs-transparency

These firms will be affected by the proposed new rules outlined in this consultation. There are likely to be a number of other pension providers who operate group pension schemes in the market, despite making no sales in 2013.

18. The Pensions Regulator (TPR) gathers data via scheme returns and disaggregates this by scheme type. Chart 2 below covers returns from 2014 – 15[9] and represents the private pension landscape in the UK, showing at a high level the different forms of employer-sponsored provision available within the private sector, and giving an overview of the size of each.

Chart 2 – The Pensions Regulator (TPR) Overview of Pensions Landscape

| | **DB** | **Hybrid: mixed benefit[2]** | **Hybrid: dual-section** | **DC (occupational)** | **DC (workplace personal)[3]** |
|---|---|---|---|---|---|
| Schemes | 5,270 | 370 | 1,010 | 36,370 | 2,310 |
| Open schemes | 820 | 60 | 480 | 28,020 | 2,070 |
| Total memberships | 7,507,000 | 890,000 | 4,879,000 | 3,632,000 | Unknown |
| Total active members | 1,305,000 | 94,000 | 717,000 | 2,592,000 | 3,016,000 |

(Sources: The Pensions Regulator's data base on scheme returns, 1 January 2015, Annual survey of hours and earnings (ASHE) 2013. Please note: ASHE reports 2.2 million active members of DC occupational schemes and 128,000 active members in schemes where the type was unknown.)

## Occupational and workplace personal pension schemes

19. There are a number of broad differences in the way in which occupational and workplace personal pension schemes are managed. With regard to occupational schemes:

- Responsibility for governing the scheme lies with a board of trustees or, in a small number of schemes (especially those established under statute), with managers.
- The trustees are the legal owners of the assets held in trust for the members and owe a fiduciary duty to the scheme's members. In this respect trustees combine the role of provider and IGC in a workplace personal pension scheme.

[9] http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2015.aspx

- The administration and investment management of the trust is typically outsourced to a single company (a 'bundled' scheme) or to several organisations (an 'unbundled' scheme). In this respect trustees are quite different from the provider of a workplace personal pension in that a provider will typically carry out the scheme administration, and also in some instances directly manage the investments.

20. Occupational schemes are very diverse, ranging from small single-employer schemes to very large multi-employer trusts. However, some differences which may have an impact on the collection and disclosure of transaction costs are shown below:

    - In some occupational schemes, the investment chain can be longer – trustees may have commissioned advisers who procure administrators and investment managers who in turn have contracted with one or more asset managers. This point is discussed in chapter 5.
    - Single employer occupational schemes may be more likely to adopt bespoke investment strategies, which bring together a mix of heterogeneous assets, rather than investing purely in units of one or more established funds.

21. Novarca's analysis and research[10], commissioned by the FCA, focused primarily on workplace personal pensions. Nevertheless, the issues for occupational pension schemes in capturing and disclosing transaction costs, and the role these can play in assessing value for money, appear to be similar to those for IGCs overseeing workplace personal pensions.

22. In the first phase of enhanced transparency, from 6 April 2015 trustees must report on those transaction costs about which they are able to get information, and providers of workplace personal pensions must use best endeavours to obtain transaction costs, which IGCs should assess.

23. It is intended that future DWP regulations and FCA rules will introduce equivalent transparency requirements on trustees of occupational pension schemes and providers of workplace personal pension schemes.

[10] Novarca report

## Types of benefit

24. Workplace pension schemes offer different types of benefits. The Pension Schemes Act 2015[11] defines three types of schemes:

    - a Defined Contribution (DC) scheme offers no pensions promise in relation to any of the retirement benefits that may be provided to the members;
    - a Defined Benefit (DB) scheme offers a full pensions promise – in addition to meeting some other conditions specified in legislation;
    - a Defined Ambition (DA) or shared risk scheme offers a promise in relation to at least some of the retirement benefits that may be offered.

25. The new governance and charges requirements being introduced from April 2015 apply to those schemes insofar as they offer money purchase benefits. However, feedback would be welcome as to whether there is a need for increased transparency of costs and charges in non-money purchase schemes more broadly[12].

26. DWP's March 2014 Command Paper consulted on whether the first phase of new requirements to report on costs and charges being introduced from April 2015 should, in the future, be extended to DB schemes to enable employers to further scrutinise the costs they are paying. Based on responses to this question, the October 2014 Command Paper concluded that it would not be appropriate at this time to include schemes within the coverage of transparency measures where the sponsoring employer already bears the scheme funding risk and should therefore already be more engaged in seeking costs and charges information. The paper also concluded that the Government's work to improve transparency in workplace money purchase schemes should ultimately benefit those running DB schemes as the new clarity about definitions and information expectations should facilitate trustees across all types of scheme to engage more effectively with investment managers. The Government also committed to keep this question under review as steps are taken to improve transparency in money purchase workplace schemes.

27. In the passage of the Pension Schemes Bill, the Government's proposition that transparency in Defined Ambition and Collective Defined Contribution Schemes

[11] At the time of publication of this Call for Evidence, the Pension Schemes Bill had not yet received Royal Assent, however it is being referred to as an Act here on the basis that Royal Assent will be given shortly as the bill has finished the Parliamentary process.

[12] Money purchase is defined in sections 181 and 181B of the Pension Schemes Act 1993. Section 181B(2) states that for a benefit to be a money purchase benefit, its rate or amount must be "calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of its provision to or in respect of the member" In other words, a funding deficit cannot arise in relation to a money purchase benefit.

would be critical was generally acknowledged. The Government intends to consider various aspects of disclosure and transparency in these types of schemes going forward, reviewing whether some or all DA schemes and collective benefits should be subject, specifically, to some or all of these new transparency requirements.

**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?**

## Market feedback

28. In order to understand the current views of the market, and taking into consideration the findings set out in Novarca's research, the FCA held a number of discussions during 2014 with some of the major providers of workplace personal pension schemes who represent about 80% of the market.

29. From March 2014 to the present, DWP has undertaken two formal consultations on Better Workplace Pensions and has engaged extensively with a wide range of consumer groups, representative bodies, pension providers and individuals on how the governance and charges measures should be applied in occupational and workplace personal pension schemes. A summary of feedback to these consultations has been published in Government response documents in October 2014 and February 2015.

30. Based on the information and evidence gathered through both FCA and DWP discussions, consultation and engagement it is clear that transparency and disclosure of investment costs varies between providers and between schemes. Some firms have done a lot of work and are already reviewing, at least internally, the cost information they disclose. Other providers however do not disclose or are not reviewing these costs at present.

31. Workplace pension providers have indicated they are supportive of increased transparency of transaction costs and most are also comfortable with needing to provide this information to IGCs and trustees. Indeed some providers are already starting to talk to IGCs about what they require and are holding teach-ins and workshops to ensure that IGCs understand more about these costs.

32. Many providers, however, are cautious about providing this information directly to end consumers as they feel it could be confusing and misleading to them and may lead to inappropriate decisions. While noting providers' concern, DWP and the FCA are committed to considering the disclosure of cost information 'up-chain' to employers and scheme members as well as to trustees and IGCs and how this could be done in a meaningful, relevant way.

33. Ultimately providers want consistency in how to approach transaction costs and in engagement with providers to date have fed back that they would favour a standardised methodology and assumptions for calculating transaction costs. It is

felt that this would ensure consistency between providers and allow IGCs and trustees to make sensible comparisons across the market. It is for providers to use this call for evidence to supply examples and feedback regarding a workable methodology and to work together with government and the FCA to develop this and drive transparent comparability.

34. It is also necessary to bear in mind that where providers do not have in house asset management or where trustees operate on an unbundled basis, transaction cost information will have to be obtained from asset managers themselves.

35. These issues are explored further in Chapters 4 and 5, seeking views and evidence about how standardised, comparable disclosure can be achieved and who disclosure requirements should apply to in order to do this.

# 3 What should transaction cost disclosure include?[13]

## Introduction

1. This chapter considers the transaction costs incurred by pension schemes. It seeks feedback on what costs should be disclosed, with a view to supporting governance bodies in understanding the value delivered by their schemes, and providing clarity and consistency across the market.
2. The first part of this chapter considers how transactions lead to costs, and the approach that transaction cost analysts have developed to analyse these costs. The chapter then considers the various costs that are sometimes described as transaction costs, seeking feedback on whether they should be captured and reported as transaction costs for disclosure purposes.
3. As set out in the previous chapter, feedback from providers and trustees suggests they would like clarity about what constitutes a transaction cost, so that there is consistency of approach across the market. The report for the Financial Services Consumer Panel by David Pitt-Watson and colleagues[14] highlights the current difficulty of obtaining a single, standard set of costs for an investment product. The objective of this chapter is to enable the development of a consistent understanding of transaction costs, through exploring how the investment return of a scheme is impacted when it transacts.

### Background

4. Transaction costs are defined in DWP draft regulations[15] and FCA published rules[16] as the costs and charges incurred as a result of the buying, selling, lending or borrowing of investments. This definition provides a high-level outline of the situations when transaction costs will be incurred.

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[13] As well as the report by Novarca, this chapter has considered the analysis of chapter 10 of Maginn J. et al. (ed) "Managing Investment Portfolios: A Dynamic Process" (3rd edition, 2007): Madhavan A., Treynor J, Wagner W. "Execution of Portfolio Decisions" and a number of other relevant academic papers, some of which are cited.
For a review of the literature on investment costs, including transaction costs, see: Pitt-Watson (2014) Appendices 3 and 4

[14] Pitt-Watson (2014)

[15] The Occupational Pension Schemes (Charges and Governance) Regulations 2015, published in draft at: http://www.legislation.gov.uk/ukdsi/2015/9780111128329/contents

[16] PS15/4

5. Investment schemes of all types incur a wide range of costs. The paper by Pitt-Watson for the Financial Services Consumer Panel undertook a wide-ranging literature review and identified a number of different costs.[17] For pension schemes, some of these are administration charges, while others are transaction costs. The categories of cost described in that paper that appear to represent transaction costs are:
    - one-off charges for entry / exit from a fund incurred within a scheme;
    - direct trading costs;
    - implicit cash costs – indirect charges such as the 'spread' between the cost of buying and selling a security;
    - stock lending and other activities;
    - non-cash costs – such as the movement in the price of securities which is caused by trading them.
6. Transaction costs are a function of several different variables:
    - the number of transactions;
    - the value of transactions;
    - the asset class in which the transaction occurs;
    - the market in which the transaction occurs;
    - the liquidity of the instrument in which the transaction occurs;
    - the tax regime;
    - the investment strategy of the asset manager;
    - the dealing / trading strategy of the asset manager.
7. The objective of an asset manager should be to maximise the scheme's return, taking into account the risks and costs of doing so. When entering into a transaction, an asset manager should factor the transaction cost into their assessment of the potential return to be generated, and the likely risk to generate that return. When an asset manager transacts on behalf of a pension scheme, there are obligations under FCA rules to provide best execution.[18]
8. Under current disclosure requirements, there has been no obligation for an asset manager of a pension scheme to provide information on transaction costs. It has therefore been difficult for those overseeing a scheme to understand the extent of transaction costs incurred. This means that they may be unable to assess whether the investment strategy is capable of making up the drag on performance created by transaction costs. Disclosure of transaction costs should make it clear to those responsible for scheme governance what cost has been incurred on their

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[17] Pitt-Watson (2014), p.11f

[18] COBS11.2 – see also TR14/13 Best execution and payment for order flow, http://www.fca.org.uk/static/documents/thematic-reviews/tr14-13.pdf

behalf to enter into transactions. This should in turn enable them to make a better assessment of the merits of the chosen investment strategy, and potentially, how it is executed.

## Ways of transacting

9. To put in context how and why investors incur transaction costs, it is useful to consider the different types of transactions that traders undertake on behalf of pension schemes. There are broadly two different ways to place an order to transact securities: as a market order or as a limit order. Most securities transactions are in essence one of these (or a combination of them).
10. Market orders are where a trader buys the securities that they want at the available market price over a period of time (which could be a few seconds or a longer period of time). This type of order emphasises immediacy of execution. However, because the trader transacts at the prevailing market price, a market order usually bears an element of price uncertainty.
11. Limit orders are where a trader sets a price limit, and is only prepared to transact at that price or a better price. This type of order emphasises price. However, the timing of the execution, or even whether the execution happens at all, is uncertain. This leads to execution uncertainty.
12. A review of the activities of the specialist firms who conduct transaction cost analysis suggests that they are seeking to capture the impact and risk of both of these ways of transacting. Part of the complexity of transaction cost analysis is that market orders incur costs in a different way from limit orders. The difference in the way that these order types generate transaction costs is discussed later in this chapter.

## The approach of transaction cost analysts to identifying transaction costs

13. Because of the different ways of transacting described above, transaction cost analysts developed the concept of “implementation shortfall”. Novarca provides a box on implementation shortfall within their report[19]. It describes the term as follows: “Implementation shortfall was originally defined as the difference between the net returns on a paper portfolio (which does not incur any transaction costs) and the net returns on a real portfolio (which does)”. It can include the “opportunity cost” of failing to transact at all, as well as the actual costs of needing to pay a higher price to buy securities (or getting a lower price when you sell securities) compared to the prevailing market price at the time the decision to transact was made.

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[19] *Novarca Report,* p.13

14. However, the use of the term “implementation shortfall” within the industry does not appear consistent. For this reason it may be preferable not to try to establish a definition of implementation shortfall. Nevertheless, the concept of implementation shortfall has implications for what might be considered a transaction cost. This paper sets out below the different elements that are sometimes considered to make up implementation shortfall (in its broadest definition), seeking feedback on whether they should be captured and disclosed as transaction costs.
15. Transaction costs can be thought of as being of two types: explicit costs and implicit costs. These two types of cost are explored in more detail below.

> Explicit and implicit costs can be illustrated by considering the example of buying foreign currency
>
> You might want to change money at a bank.
>
> On a given day, you may be quoted a rate of 1.10 euros to the pound if you wish to buy euros. The bank will also quote a rate to buy euros back from you. This may be 1.30 euros to the pound. The difference between the rate at which you can buy euros and the rate at which you can sell them back is called the spread.
>
> Some banks charge commission, while others do not. The commission charge is an explicit cost, while the spread charge is an implicit cost. A bank that charges commission will normally give you a better exchange rate, and typically offer a narrower spread than one that does not. When comparing prices, you need to take into account both explicit and implicit charges, as an apparently “commission free” deal may not be the best deal available to you.
>
> The bank will hedge its exposure to foreign currency in the wholesale markets, making a profit relative to the rate that it has charged you. If the bank has also charged you a commission, it will be able to make the same profit while offering you a better exchange rate. The bank profits in essentially the same way whether you are charged an explicit charge (commission) or an implicit charge (spread).

## Explicit costs

16. When an asset manager transacts on behalf of a pension scheme, some costs that are incurred are explicit. Explicit costs are the direct costs of transacting. Examples of explicit costs are commissions charged on orders executed by brokers, fees charged by custodians for clearing and settlement, and taxes such as stamp duty. Because such costs are explicitly charged, the assumption of this paper is that it should be relatively straightforward for providers to identify and

calculate their explicit transaction costs at the level of the underlying investments of the scheme. There may be some additional complexity where schemes invest in funds or layers of funds, and feedback on this issue would be welcome. This point is covered in more detail in Chapter 4.

### Implicit costs

17. There are also other costs that pension schemes incur when they transact. These costs could be described as implicit. Implicit costs represent indirect transaction costs. Usually no receipt is given for implicit costs, but they are recognised by market participants as real costs (see box on foreign exchange).
18. However, because implicit costs are not directly billed to clients, there can be some challenges with reporting them. To calculate an implicit cost, it is normally necessary to make assumptions. In some instances this will be easier than others.
19. There are a number of different types of implicit cost presented in transaction cost research, including in Novarca's report commissioned by the FCA. These are often broadly grouped into two categories: costs that are implicit but reasonably visible and certain, and costs that are implicit but quite subjective.[20] The section below considers the different types of implicit cost with a view to establishing whether they are transaction costs that ought to be captured and reported.

## Types of implicit transaction costs

### Bid-ask spread

20. The bid-ask spread is the difference between the price at which someone is prepared to buy an asset from you and the price for which they will sell you the same asset (as illustrated in the foreign exchange example).
21. For transactions where there are few or no explicit costs, costs are normally embedded into the bid-ask spread.
22. In some cases the exact spread paid may be identifiable, such as in some equity markets, where market-makers continuously publish quotes throughout the trading day, and these are publicly consolidated by an exchange. In other situations it might not be possible to observe the exact spread at the moment the transaction is carried out, such as in the Eurobond market where quotes and transactions are not continuously and systematically published.
23. However even in the latter case, it should be possible to work out an approximate or usual spread for most instruments (where there is some liquidity). The Dutch

[20] Cf. Blake D., 'On the Disclosure of the Costs of Investment Management' Pensions Institute Discussion Paper PI-1407 (May 2014) - http://www.pensions-institute.org/workingpapers/wp1407.pdf

model for calculating transaction costs allows different approaches where a manager either calculates the actual spread themselves, or uses the average spread of the previous quarter, or uses a standard spread.[21]

**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?**

## Market impact

24. Market impact is the cost of the amount that the market moves against you when you start dealing. The presence of a buyer (or seller) in the market will move the market higher (or lower) than it would otherwise have been. For example, if a trader places an order to buy a security steadily over the course of a day in a series of transactions, the price of the security would be expected to rise in response to the fact that there is a buyer in the market. Novarca states that high quality estimates of market impact are available from brokers and specialist transaction cost analysis firms.

25. For orders that are too large to execute in a single transaction, market impact might constitute a significant component of the costs of transacting. This type of market impact cost might potentially be considered an extension of the spread cost.

**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 impact costs? What practical challenges are there in calculating market impact costs? Do you have any views on 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?**

## Missed trade opportunity costs and delay costs

26. There are other types of cost that are described in the literature as transaction costs. Two widely cited examples of this are: first the "opportunity costs" of failing to transact at all (for example because the price has moved before the order was completed); and second the "delay costs" of transacting (where it takes a period

[21] Federation of the Dutch pension funds, 'Recommendations on administrative costs 2012' p.50 (available in English at http://www.pensioenfederatie.nl/Document/Publicaties/Servicedocumenten/Uitvoeringskosten_no2_English.pdf, updated guidance is available in Dutch and suggests that the preferred approach should be the actual spread, where the data is available http://www.pensioenfederatie.nl/Document/Publicaties/Servicedocumenten/Aanbevelingen_uitvoeringskosten_2013_herziene_versie.pdf pp.65-6)

of time to transact) and the value of the asset being purchased has risen (or the value of the asset being sold has fallen).

27. It appears that some transaction cost analysis firms undertake analysis of the transactions of asset managers along these lines, using data about when investment decisions were taken and what the intentions of the investment manager were. However, it is unclear whether such data is easily available on a systematic basis to all market participants for all assets.

28. There are reasons why it would be desirable for all such cost elements to be captured. The intention of reporting transaction costs is to give governance bodies and consumers an accurate assessment of the costs that are being incurred on their behalf. Capturing missed trade "opportunity costs" and "delay costs" is a way of including the effects of using limit orders rather than market orders. Not including such costs could potentially incentivise traders to use limit orders (or to characterise their orders as limit orders) rather than market orders, since these would incur fewer reportable transaction costs.

29. However, this appears to be a difficult area. Opportunity costs are unlikely to fall within the definition of a transaction cost outlined in paragraph 8 of this chapter, as no transaction has taken place. "Delay costs" involve some subjective assessment of the size and nature of the original order, which creates a risk of gaming. Novarca's report suggests that it may be ultimately possible to overcome the practical challenges around reporting in the event that such costs are captured and reported as transaction costs, but any feedback in this area would be welcome.

    **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? If not, why not? 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?**

## Other considerations around the disclosure of implicit costs

30. There are some other considerations that a review of the disclosure of implicit costs needs to bear in mind.

31. Explicit costs can be converted into implicit costs. For example, one transaction may be charged an explicit commission, while a similar transaction may have an implicit commission charge built into the price (as with the foreign exchange example – see box). In some equity markets, traders may make choices at the point of transaction as to whether to incur a cost as an implicit or explicit cost. In bond markets, market practice appears to be that all (or almost all) transaction

costs are implicit. It would clearly be of limited use to those reviewing transaction costs only to be able to see costs that have been incurred on an explicit basis.

32. Another issue that is sometimes raised concerning different types of implicit cost is whether something is only a cost if someone in the investment value-chain benefits from it. For example, where a broker charges a spread, they would typically do so in anticipation of making a profit, perhaps by offsetting the position at a better price in the wholesale market. For other types of cost, it may be less clear that anyone involved in the transaction is directly benefitting. For example, where someone buying a security causes the price of that security to rise, the existing holders of the security will see an uplift in valuation, but typically the parties involved in facilitating the transaction are not making a specific profit from this. However, the pension scheme conducting the transaction may have incurred a cost, even if no other specific party has benefited from this cost. Feedback would be welcome on whether this is a relevant consideration in establishing whether something should be reported as a transaction cost.

**Question 5: Do you have any further thoughts on the analysis of transaction costs outlined in this chapter? Are there any alternative approaches to identifying transaction costs, or other considerations to take into account?**

# 4 Transaction cost disclosure in practice

## Introduction

1. This chapter considers the practical issues that may exist around delivering consistent disclosure of transaction costs. It seeks feedback on how costs should be captured, what other information should be provided alongside transaction costs, and how the disclosure regime might work in practice.
2. The chapter sets out some frameworks within which transaction costs might be disclosed. It considers other practical issues such as the extent to which pension schemes should look through to transaction costs incurred in underlying investments. It then discusses the potential ways in which transaction costs might be calculated, and considers how disclosure reports might look, including what information might need to be provided alongside disclosure reports to put them in context.
3. An important consideration in selecting an approach is the usefulness of the information to trustees, IGCs and ultimately members. However, there will be costs involved in providing or obtaining information on transaction costs, depending on the approach taken, and these should be in proportion to the usefulness of the information provided.

## How might the information be structured in reports?

4. The objective of providing governance bodies with information on transaction costs is to enable them to understand better the costs that their schemes are incurring and to include these when they assess value for money. Within a workplace pension scheme, individual members or groups of members will incur different transaction costs dependent on the specific funds or investment strategies that each member is invested in.
5. There are a number of ways in which it would be possible to present transaction costs. For example they could be reported by fund, by asset class, by asset manager or by employer (or group of employers), or by a combination of these, and amalgamated or broken down to different levels of granularity.
6. Each approach has advantages and disadvantages. If more information were provided, on a more granular basis, governance bodies would be able to oversee specific costs in greater detail. However, excessive detail may make it impossible for governance bodies to focus on the key issues, and may obscure their

understanding of whether the scheme overall is getting good value for money. By contrast, if information is amalgamated at too high a level, governance bodies may be unable to understand where transaction costs are being incurred, drawing unwarranted conclusions from the data, or being unable to draw conclusions at all.

## How might an approach work in practice?

7. Novarca has suggested an asset class approach might be one possible way to approach transaction cost reporting. Such an approach would enable governance bodies to oversee the costs incurred within each asset class for each fund manager, condensing the level of information whilst allowing some comparison of data across and within different schemes. Novarca suggests that this approach can also be relatively easily adopted by providers, with assistance from fund managers, without significant investment in new IT systems.
8. An asset class approach would reduce the complexity of transaction cost reporting. The disadvantage is that there would not be direct oversight of the transaction cost experience for an individual fund, which means that in many or most cases it would not be possible to determine the level of transaction costs paid by members or employers.
9. There are also a number of practical decisions that would need to be taken about how exposures are amalgamated. For example, it would be misleading for employers and scheme members whose equity investments are largely in US blue chip companies to be provided with a report on costs which is skewed by the transaction costs of emerging market smaller companies. Similarly, where the platform of a pension provider or a large master trust features a range of funds provided by a single asset manager, invested in a single asset class with very wide-ranging transaction costs, it would be misleading for governance bodies to be provided with a single average figure, which will not represent the range of charges faced by the range of members invested in those asset classes. Being presented with information that is misleading could lead to governance bodies, employers or members making poor decisions.
10. There is therefore an argument for presenting data which is broken down to individual fund level, instead of by asset class. Feedback from workplace personal pension providers suggests that the structure of a workplace pension scheme can be quite complex, and there may be quite a large number of individual funds and investment approaches available to members, making disclosure at an individual fund level potentially rather complex.
11. Even with this level of detail, many funds invest in a number of different asset classes, so it may not always be trivial to understand whether a certain level of transaction costs represents good value for money for that fund, and where within the fund higher costs are being incurred. Reporting transaction costs both by fund and by asset class within each fund, might address this issue, but it will

significantly increase the volume of information which governance bodies need to review. Feedback from pension providers suggested that there may also be challenges with producing such granular information given existing IT capabilities.

12. An alternative which could also be considered is to break down transaction costs to a more granular level of detail (for example by fund, or by asset class when it is already broken down by fund) when the total funds under management are above a certain threshold, account for a threshold percentage of funds under management or of scheme members, or when they are in use as default funds in schemes used for automatic enrolment.[22]

13. Another alternative is to use a more granular set of asset classes and to report by investment type, to provide more meaningful information. For example, equities could be split into developed and emerging markets, and bonds into Government, investment grade and high yield. Given the different transaction cost profiles of active and passive investment approaches, it may also be helpful for governance bodies to see transaction costs within asset classes split between active and passive.

14. A question related to any approach is what detail ought to be provided for funds which are made up of others, which may on occasion consist of further funds. This issue is explored in more detail below.

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

## Costs at the product level

15. There are different layers within a pension scheme where transaction costs might be incurred. Since pension schemes invest in funds and other types of investment scheme, which themselves invest in underlying investments, there are a number of levels at which transaction costs might occur. For example, a scheme might invest in a fund of funds, which then invests in a number of investment funds, which in turn hold underlying investments. Transaction costs may be incurred when the scheme transacts in the fund of funds, when the fund of funds transacts in the investment funds, and when those funds transact in their investments.

16. So, while most transaction costs will normally be incurred within the underlying portfolios, some costs will be incurred as a result of movements between funds in which the scheme invests. In these cases, transaction costs, such as entry and exit charges or spread costs, could be captured at the product level. These costs might be incurred for a range of reasons, including:

[22] Respondents should note that a default fund is defined in both the DWP charges and governance regulations and the FCA rules on charges in workplace personal pensions at employer level, so a provider or trustee will often have more than one default.

- active investment decisions e.g. asset allocation to equities because the asset manager believes them to offer attractive returns;
- passive investment decisions e.g. where a scheme has a 75% equity / 25% bond target, market movements will lead to this changing, and the scheme manager will take action to reweight the portfolio;
- structural reasons e.g. the scheme offers a lifestyling approach that systematically reduces the weighting in riskier assets over a period of time.

17. In some circumstances, for example, when markets are quite volatile and the asset manager regularly rebalances between bonds and equities, product level costs could be quite significant.
18. Some transaction costs incurred at the product level are charged only to those to whom it is relevant e.g. members switching between funds. Industry practices to prevent dilution[23] are intended to pass transaction costs on to the relevant party. There may be an argument for excluding these costs from reporting on the basis that they are only relevant to specific members.
19. The cost of entry into and exit from the funds for those who incur the transaction costs directly could then be captured separately.
20. Some trustees or IGCs may have a particular interest in these product level transactions costs precisely because of their scheme's investment approach. However, this may pose costs and challenges, and feedback would be welcome on the practicalities of doing this.
21. There may also be other costs incurred at a product level e.g. set-up costs that are charged to a fund or amortised over the initial period of operation of a fund. Scheme level entry costs should only be considered as transaction costs to the extent that they result specifically from the costs associated with purchasing the underlying assets. Where these costs relate to other activities, for example, setting up account details and payment arrangements these would constitute administration charges and, where applicable, be subject to the charge cap.

**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?**

[23] Dilution represents the transaction costs incurred in an investment scheme when assets are bought as investors enter the scheme, or are sold as investors exit. Dilution has a negative impact on the ongoing holders in the investment scheme.

## Look-through costs

22. Novarca notes in its report[24] the importance of avoiding any inadvertent incentivisation for asset managers to get around the disclosure regime by choosing to invest in listed, exchange-traded vehicles such as ETFs and not disclosing the underlying transaction costs resulting from holding the vehicle. This may also be relevant where workplace pension schemes obtain access to asset classes (e.g. property, private equity) through listed vehicles.

23. In practice, there may be some challenges in ensuring that all relevant look-through costs are reported. It should be fairly straightforward for an investor to identify the (historical) management costs of a listed investment vehicle, based on the report and accounts of the scheme. However, such vehicles are not currently under any obligation to report their transaction costs, so information about these may be harder to obtain.

24. To reduce the risk of market distortion from different transaction cost disclosure requirements on pension schemes using listed vehicles, it may well be necessary to require schemes to report the transaction costs of such vehicles on a look-through basis. There are a number of types of listed vehicles that have been established for the purposes of investment, for example ETFs and other exchange-traded investment products, investment trusts, REITs, private equity vehicles and listed hedge funds.

25. Where schemes have invested in these instruments, there is a clear benefit in IGCs and trustees having a view of the costs and charges. However, there may be practical limitations which make it difficult for pension schemes to obtain the necessary information on transaction costs for these vehicles. While this may be challenging, it could potentially be a significant gap in the regime if such investments were not subject to transaction cost disclosure.

26. Where pension schemes have obtained access to asset classes such as property, private equity and hedge funds through listed, exchange-traded investments, they may incur high levels of transaction costs, and those transaction costs may be incurred within an underlying vehicle that is not directly held by the investment scheme. For example, property may be owned by a special purpose vehicle, which is in turn owned by an investment scheme.

27. It is likely that many schemes will have exposure to property, either directly or through pooling vehicles. Schemes may also have exposure to other real assets such as infrastructure or commodities.

**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**

[24] *Novarca Report* p.21

**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?**

28. In a similar way, there may be a need to look through the exposures provided by derivatives. The report by Novarca categorised derivatives as a separate asset class for evaluation and reporting purposes. Feedback would be welcome on whether governance bodies would find it helpful to see the transaction costs associated with derivatives reported separately from those incurred within the underlying asset class.

29. An alternative approach would be to look through derivatives to the underlying asset, and to include the costs of derivatives within the costs of the underlying asset. This has the advantage that it links instruments with the same economic exposure. It has the disadvantage that it does not allow the costs of derivative transactions to be separately identified. A further approach would involve the transaction costs associated with derivatives being reported both within the asset class they provide exposure to and separately.

30. It is also possible to use derivatives to access a particular payout profile, for example through a structured product. The use of such structured products does not currently appear to be widespread among workplace pension schemes, but their attractiveness and therefore their use may increase over time.

**Question 9: Do you have any comments on the treatment of derivatives? Should the costs of derivatives be disclosed separately somewhere within the disclosure reports? Do you have any comment about the transaction costs associated with structured products?**

# How should transaction costs be captured?

31. This section considers the technical challenges in calculating transaction costs. Firms have indicated that they would like to see clear, standard approaches to calculating transaction costs. However, this may be harder to achieve in practice, given the wide variety of such costs that are incurred, as well as the range of different asset classes (and other factors such as geography), where market practices differ.

32. Transaction cost disclosure will need to strike a balance between achieving accuracy sufficient to be of value to governance bodies and the cost of obtaining accurate information. While some information is readily available, there may be substantial costs associated with collecting other types of information on an accurate basis. This section seeks feedback on the different potential approaches to capturing transaction costs.

## Standardised approach versus actual costs

33. There are broadly two ways to disclose costs: one is to disclose the actual costs that are incurred when transacting (based on a set methodology); the other is to create standardised models of costs for particular types of transactions, and for firms to apply these to all of the transactions that they undertake. Given the benefits of and issues with each approach, it may be attractive to use a hybrid of the two methodologies. Each has advantages and disadvantages, and this paper seeks feedback on the different options.

## Standardised models

34. Academic research has often been conducted without access to underlying transaction data of funds to calculate transaction costs.[25] It has therefore tended to use standardised models of some description to estimate the unit transaction cost for transactions in a particular type of security, and then multiplied those unit transaction costs by the volume of transactions undertaken by a fund. In this way, researchers come up with an estimate of transaction costs.

35. One approach to the disclosure of transaction costs is to operate a model like this that can be used by all market participants to estimate their transaction costs. The unit transaction costs could be provided centrally by Government or regulators, or could be developed at trustee, provider or fund manager level according to clear principles or a methodology set down centrally. Providers could choose between using central costs or developing their own model for different asset classes. Where the model is developed at trustee, provider or fund manager level, a principles-based regime is likely to be preferable, given the complexity and risk of creating arbitrage opportunities.

36. This approach has a number of attractions to it; it is comparatively easy to calculate the transaction costs for any portfolio or combination of portfolios, without undertaking analysis of actual market trades or prices. The asset manager takes all of their transactions, categorises each transaction into a standard category and then uses a standard number to calculate the implied cost of each transaction. This makes it a lower cost approach. It would also be relatively straightforward to audit such an approach, and it would remove the risk of perverse incentives to under-estimate individual transaction costs.

37. The main disadvantage with such an approach is that it does not capture the actual costs incurred by the manager. This will reduce the value of the disclosure as it will give governance bodies limited ability to put pressure on providers to get value for money from their transaction costs. This could lead to a lack of competition between providers. It also involves capturing costs in a manner that

[25] Cf Edelen R., Evans R., Kadlec G. "Shedding Light on "Invisible" Costs: Trading Costs and Mutual Fund Performance" Financial Analysts Journal 69(1) Jan/Feb 2013

effectively sees them as static (at least for a period of time), as the standard models would only be updated from time to time. It may require significant set-up costs on the part of Government, regulators, providers or fund managers to establish the relevant categories (which would need to be much more granular than “asset class”), and then ongoing costs to maintain these.

## Actual costs

38. There are some areas where it should be straightforward to calculate the actual costs that a scheme incurs. An example of this is an explicit cost such as dealing commission. However in other areas, for example for some types of implicit costs, calculation of actual costs may be significantly more complex and subject to interpretation and errors.
39. Disclosure of actual costs should give governance bodies and consumers a better understanding of the true costs of transacting. It would be significantly easier and clearer for governance bodies to carry out the function of assessing the value delivered on their behalf by providers and asset managers if the costs reported were the actual costs. It would also be clearer which costs were within the control of the provider / asset manager.
40. If disclosure reports were only to present actual costs, there would need to be clear definitions of all of these costs to ensure consistency. Providers and fund managers could be permitted to use snapshots or sampling to identify an actual cost which could be applied across all transactions of a similar type in a given reporting year, but care would need to be taken to ensure that costs were genuinely representative.
41. However, this increases the risk that the rules would not be resilient to changes in market practice or structure, or that the rules would unintentionally incentivise or disincentivise certain behaviours. There is also the risk that rules would be costly to implement, but create disclosure reports that have a spurious level of accuracy.
42. If actual costs are used as the basis for reporting, and if implicit costs such as market impact are reported, there is the potential that sometimes reportable transaction costs might be negative (where for example a fund is a small seller while there is a large buyer in the market). This may be chance, or it may reflect the investment strategy or dealing style of the asset manager. It might be more informative for reports to highlight aggregated costs, subtracting negative costs from positive ones. Alternatively, it might be more helpful to report negative costs separately from positive costs, as negative costs may distort the overall picture of transaction costs.

## Hybrid approach

43. Another potential option is to allow a hybrid approach between reporting actual costs and reporting costs via a standardised model. This would enable firms to

report actual costs in some areas while reporting modelled costs in other areas. Firms or trustees could be required to use actual costs for some categories, or given the option as to when they should use actual costs, and when they could use standard numbers. Such an approach should reduce the complexity of reporting actual costs, particularly for some types of assets, while keeping as far as possible a report of the actual costs incurred by the scheme.

44. The construction of such a hybrid approach may be attractive in that it obtains most of the benefits of reporting actual costs while ensuring the costs of producing the information are proportionate. The approach set out by Novarca in its report is along these lines. They note which costs they believe can be captured as actual costs and which could be modelled.

45. There is a risk that those reviewing the costs will find it difficult to understand when they are looking at actual costs and when they are looking at theoretical costs based on a model. This could be mitigated by clear communication.

46. Another risk is that firms might report whichever of actual or standardised costs is lower. The lack of incentive to control costs which are reported using a standardised model would remain. There may also not be sufficient incentive for firms to move from a standardised model towards actual cost reporting.

47. As mentioned above under standardised models, there are two ways that a hybrid approach could be operated. One is to set out a series of principles within which firms are expected to operate. The other is to define in some detail how each type of cost should be treated. Given the complexity and risk of creating arbitrage opportunities, a principles-based regime is likely to be preferable, but feedback would be welcome in this area.

**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?**

# What other information should be presented?

48. Transaction costs presented without the context of other information may present a confusing or misleading picture of an investment. So, when governance bodies review transaction costs, they are likely to find it helpful to do so in conjunction with other information. While it would not be possible to specify all the other information that a governance body might wish to review when considering transaction costs, there is some basic information that may put in context the information presented on transaction costs. Feedback would be welcome on whether some or all of the metrics below should be systematically reported alongside transaction costs and, if so, how they ought to be reported.

## Portfolio turnover

49. Portfolio turnover is the most important contextual information for transaction costs. For a given asset class, there is likely to be a high degree of correlation between the total value of turnover during a given period and the transaction costs incurred. Portfolio turnover can be used to calculate unit transaction costs i.e. how much each unit of turnover cost, which is likely to be of use for considering value for money and for benchmarking.

50. There are different methodologies for calculating portfolio turnover, which may be broadly described as adjusting the actual turnover for transactions that relate to flows into and out of the product. Any disclosure of the Portfolio Turnover Rate (PTR) would need to be aligned to the methodology used to calculate transaction costs.

51. For example, if the final approach sought to capture product level costs separately, it may be better to use a PTR calculation that strips out a fund's net inflows and outflows and shows only turnover resulting from discretionary investment decisions[26]. The basis for calculating the PTR would then broadly reflect the basis for calculating transaction costs. If product level costs were not captured separately, it may be better to use a methodology without an adjustment to reflect investor flows.

52. The turnover, and therefore the transaction costs, of passively managed assets will usually be much lower than for actively managed assets. However portfolio turnover will also vary widely between actively managed funds, including those of a given provider, depending on whether the manager pursues a buy-and-hold strategy or a much more active approach.

53. Further opinions on the merits and demerits of the different methodologies for calculating the PTR have been set out in the Investment Association's report on "Meaningful disclosure of costs and charges".[27]

**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?**

## Risk / return

54. Other contextual information could be reported on the return and risk of the fund. This could enable governance bodies to understand whether the transaction costs

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[26] For example the methodology previously used for the calculation of PTR as disclosed in the simplified prospectus for UCITS funds

[27] Chapter 2 , available at http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

they have incurred have led to additional return (or reduced risk), and to contextualise the amount of risk that the fund is taking.

55. Risk and return information would normally be reported to governance bodies and scheme members on a systematic basis. However, it may not be straightforward to reconcile the information with transaction cost disclosure reports.

56. There are a number of different ways of thinking about investment risk. Purely quantitative measures include for example realised historical tracking error, predicted future tracking error and volatility of return. More advanced measures of risk use stress-tested or simulated performance to assess risk. Some of these measures are forward-looking, while others are backward-looking. Other assessments of risk may be more qualitative in nature. Measures of risk are contained within other regulations, for example within the UCITS Key Investor Information Document, and may be able to be adapted to provide context to the risks run by workplace pension schemes.

**Question 12: Do governance bodies need risk and return information to be reported alongside transaction costs, or is it sufficiently readily available to them from other sources, considering the balance of costs and benefits that such new requirements may impose? If you think risk information should be reported, do you have any feedback on the best risk measures to use when considering transaction costs?**

## Benchmarks

57. Where actual data is used, there may be value in establishing benchmarks to enable governance bodies to compare the costs of their schemes to those of other providers. Novarca raises the potential for benchmarks to be established in its report[28] and feedback would be welcomed on the benefits and costs of setting up benchmarks.

58. More detailed benchmark information will take some time to build up, and needs an adequate number of participants to make it sufficiently anonymous, but it could have significant benefits in terms of enabling governance bodies and scheme members to assess the performance of the provider / asset manager and to challenge them where appropriate.

59. There would obviously be costs involved in collating benchmark transaction costs including the cost for the FCA or one or more third parties to collect benchmark data and publish it. There might also be issues of confidentiality, but the costs of collecting the information could be outweighed by the benefits.

60. Because of the need to develop comparable data, benchmark data would take time to construct, and would be unlikely to be available for governance bodies initially, unless providers were prepared to conduct historical analysis to submit to

[28] Novarca Report, p.29

a benchmark calculation. Nevertheless, there are already some transaction cost benchmarks published.[29]

61. Because of the potential value of benchmarking to enable effective oversight and challenge of transaction costs, feedback would be welcome on benchmarking.

**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?**

# What income should be disclosed?

62. Those in the investment value-chain might have other ways of earning income at the expense of the pension scheme. Some potential areas where costs might need to be disclosed are securities lending and foreign exchange. Full disclosure of all of these costs would provide greater transparency and reduce the risk that costs are "hidden". Feedback would be welcome on any other areas of cost that are incurred and how they might be disclosed.

## Costs associated with securities lending

63. Securities lending arrangements are generally set up so that the revenue from the securities loaned is paid partly to the scheme and partly to one or more agents. The agents may charge fees to the scheme, or they may set up an arrangement to share revenues. Irrespective of how securities lending is structured it would appear that, in substance, remuneration paid to a securities lending agent is a cost to a scheme. Securities lending arrangements appear equivalent to other explicit costs, and they fall within the definition of transaction costs.

## Costs associated with foreign exchange

64. There are a number of foreign exchange costs that are incurred by funds. These are normally incurred on an implicit basis. Some foreign exchange costs may be associated with specific transactions e.g. exchanging currency to meet settlement requirements. Other foreign exchange costs may result from other activities within a fund – for example, corporate actions, dividend payments. Many funds use services from custodians ("FX sweep") to return balances to the base currency of the fund. At the same time, holding balances in different currencies could lead to costs, for example if balances in certain currencies are held in non-interest-bearing accounts. At a minimum, foreign exchange transactions will lead to implicit spread costs.

[29] For example by ITG, http://www.itg.com/marketing/ITG_GlobalCostReview_Q12014_20140801.pdf

## Other costs

65. It is sometimes suggested that asset managers or product providers generate other types of hidden revenue streams from their products. It would be helpful to obtain any feedback on practices either known or suspected that may be creating additional costs for investors or generating additional "hidden" revenues for providers.

    **Question 14: Do you have any feedback on the reporting of the costs of securities lending, foreign exchange and related activities, and on how these should be reported? Are there any other areas or practices that you would highlight where providers are imposing additional costs or generating "hidden" revenues?**

# Presenting costs and charges information

66. This chapter has presented a number of possible ways of categorising, calculating and reporting transaction costs and some of the practical considerations in pursuing each of these methods. The ultimate aim of making rules for a further phase of enhanced transparency is to drive a workplace pensions market where charges and costs are clearer and where those making decisions about schemes, products and investments can easily understand the value they are achieving for members, so that they can compare if they could obtain better value by making different choices.
67. Providers have reported that consistency and standardisation will be key to ensuring comparability. Views are therefore sought on what steps could be taken to support future rules and regulations to ensure standardised and comparable disclosure. There are a range of options for achieving this, from detailed regulatory requirements, to guidance, industry codes and templates. There may be other considerations to be taken into account – for example how far standardisation is needed in reports from asset managers to governance bodies, as opposed to standardisation in publicly reported information.

68. The report by Novarca includes an example template of how a cost report might look[30] which is reproduced below. For transaction costs it is based on the framework for reporting costs that has been outlined in this paper. Many of the issues around the presentation of the information contained in such a report have been explored in other sections of this paper. However, feedback would be welcome on any aspects of the presentation of the information in a report.

**Chart 8: scheme-level value-for-money cost reporting template**

| Cost report 2014 | | |
|---|---|---|
| Total AUM: £ | Total costs: £ | |
| **Vehicle/structure costs** | | |
| | bp | Total |
| Switching | | |
| Portfolio-level costs | | |

| **Holding costs** | Custody (bp) | Securities lending | | Interest income | | Foreign exchange (bp) | Fund admin-istration (bp) | Audit (bp) | Tax/ regulatory (bp) | Total holding costs (bp) |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Income (bp) | Paid out (%) | Income (bp) | Paid out (%) | | | | | |
| All assets | | | | | | | | | | |

| **Managing costs** | AUM (£) | Asset management fees (bp) | Performance fees (bp)* | Look-through costs (bp)* | Total managing costs (bp) |
|---|---|---|---|---|---|
| Developed equity[10] | | | | | |
| Fixed income | | | | | |
| Private equity | | | | | |
| Commodities | | | | | |
| etc... | | | | | |

| **Transaction costs** | Broker costs (bp) | Custodian ticket fees (bp) | Taxes (bp) | Market impact (bp) | Spread (bp) | Total transaction costs (bp) | Total managing plus transaction costs (bp) | Return (%) | Risk (%) | Turnover (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| Developed equity | | | | | | | | | | |
| Fixed income | | | | | | | | | | |
| Private equity | | | | | | | | | | |
| Commodities | | | | | | | | | | |
| etc... | | | | | | | | | | |

*if applicable

[10] illustration only, categories to be determined, e.g. inclusion of currency overlays

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**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? How can the data be presented so it is of use to making ongoing decisions as well as a matter of historical record?**

69. For transaction cost information to be of use to governance bodies of pension schemes, it is likely that they will want not only to look at historical reports of what their scheme has done, but also to consider what the scheme might do in the future.

[30] Novarca Report, page 36

70. To predict transaction costs, a scheme will have to do two things: predict the volume of transactions (portfolio turnover), and predict the transaction cost for each unit of turnover. It may be a reasonable assumption that the unit transaction cost from the historical period (e.g. for each asset class) is a reasonable predictor of the forward-looking unit transaction cost. Turnover may be more variable over time, and the manager may have reason to believe that turnover will be higher or lower than the previous period, e.g. for an index fund there may have been an abnormally high level of index changes at one point in time; or for an active fund turnover may have been distorted by a major change in investment strategy, for example because of a change in investment manager, which will not be replicated in the next period.

71. To allow the governance body to assess the likely future transaction costs, the provider could inform the governance body of any reasons why turnover rates are likely to be different in the forthcoming period from the previous period.

**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?**

## Consequences of transaction cost disclosure in pension schemes

72. Novarca's report recognised that measuring transaction costs could result in changes in asset manager and provider behaviour. Some behavioural changes may be desirable – for example, greater consideration of the costs and benefits of a particular trade, and securing the best market price for a sale or purchase of an asset. However, other consequences could be less desirable. For example asset managers may choose to transact in a particular way or to use different types of instrument to avoid reporting transaction costs. The framework set out in this chapter seeks to address these issues, but feedback would be welcome on any other risks around changing behaviours and how these might be mitigated.

**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?**

# 5 Wider issues and considerations

1. The main focus of this call for evidence has been on the identification and reporting of transaction cost information from providers and asset managers to IGCs and pension scheme trustees. However the Pensions Act 2014 places a duty on the Government and the FCA to make rules and regulations requiring the disclosure of some or all transaction cost information to members and / or other prescribed persons, and the publication of information about transaction costs and administration charges.
2. This chapter therefore focuses on how trustees and IGCs will receive transaction cost information to enable them to disclose it further and to whom that information should be communicated. It seeks views on ways by which standardised, meaningful, comparable disclosure of costs and charges may be achieved. It also considers where in the supply chain the duties to report transaction costs should lie. The chapter goes on to consider the wider context of reform and seeks views on further governance requirements in relation to investment information.

## How will trustees and IGCs obtain transaction cost information?

3. From April 2015, trustees and IGCs will be required to report on transaction costs for the first time. Providers of workplace personal pensions will be responsible for furnishing IGCs with information on transaction costs, but depending on the structure of scheme they provide, trustees will need to obtain information from different parties. For example, trustees of an unbundled occupational scheme would need to obtain information from its asset managers, while trustees of bundled occupational schemes would need to go to the provider of their bundled arrangement. Pension providers may also face challenges depending on whether investments are managed by their own asset management arm or by a third party.
4. The regulations and rules bringing in the first phase of reporting on transaction costs apply to trustees and workplace pension providers, respectively. Flexibility has been built into these requirements to recognise that in some cases it may not be possible for trustees, providers and IGCs to obtain and report on full information on transaction costs, in this first phase.
5. The duty in the Pensions Act 2014, that requires the DWP and the FCA to make regulations and rules to bring in the next phase of transaction cost reporting, allows for further duties to be put on trustees and IGCs to disclose this

information. However to do this effectively, trustees and IGCs must be able to obtain a greater level of information on costs.

6. This call for evidence seeks feedback on the capacity of trustees, providers and IGCs to obtain this information. In particular feedback would be welcome on whether the way that pension scheme assets are managed means that new duties may be required on other parties in the chain (such as asset managers) to disclose information to governing bodies, as well as on governing bodies to report this.
7. There may be scenarios where obtaining this information is a particular challenge. For example, as discussed in Chapter 4, where providers might look through to the transaction costs of listed vehicles, the transaction costs may not be easily available to them, which could suggest a case for making rules to require managers of listed investment schemes to report their transaction costs to pension providers. However, such a requirement may create an unnecessary burden on providers of listed investment products, particularly if they have no investors who are workplace pension schemes.

   **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?**

# Provision of information to employers and members

8. The duties in the Pensions Act 2014 require information about charges and transaction costs to be provided to members and other beneficiaries. Key recipients of information about transaction costs are those participants in the value chain who make decisions about scheme choice. While trustees, pension providers and IGCs are responsible for taking or overseeing many decisions about running a scheme, employers also play a fundamental role in selecting a pension scheme to offer to their employees.
9. There are different points at which information about transaction costs may be useful to employers, most notably when they are selecting a scheme to offer to their employees; when they are selecting funds within this scheme to be made available; and any point at which they review their scheme choice. Many employers will use an adviser or consultant to advise them in these exercises.
10. Scheme members may also benefit from information about transaction costs within their scheme, particularly if they want to consider selecting an investment option other than the default fund. There could also be a role for transaction cost information provided through an annual statement to empower members to

consider whether their pension savings are invested in the appropriate fund, and the value this is delivering.

11. However, as was pointed out very clearly in responses to the Government's Better Workplace Pensions Command Papers, proposals for providing transaction cost information to members should be carefully weighed with considerations of proportionality and relevance. Respondents were very clear that members should not be provided with information that may be confusing, difficult to understand or may drive perverse behaviour.

12. The success of any disclosure is measured by the way it influences reader behaviour. Therefore any cost information disclosed to members should be understandable and relevant, and presented in a format that contains sufficient, yet succinct, information to inform the member.

13. For these reasons, it is not likely to be appropriate to provide transaction cost information to employers and members at the level of detail given to and reported by IGCs and trustees in their annual report, and many respondents to the DWP consultations during 2014 stated this view.

14. With this in mind, feedback is sought on what information employers and members should receive on transaction costs, and how this should be provided, in addition to the annual Chair's statement. For example, it may be more appropriate to disclose a single aggregated transaction cost figure to employers and members, possibly at an individual fund level and possibly make more detailed information available on request. Existing products, such as the Statutory Money Purchase Illustration (SMPI) provided to members annually, could be used for regular communications, or there could be a new communication particularly for employers using the scheme for their employees.

15. Furthermore, providing a member with information in isolation about the scheme or fund they hold, or which their employer has chosen, is unlikely to enable comparisons between schemes or funds. For this reason, consideration needs to be given as to how information is made available to facilitate comparisons. This is covered in the next section.

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

# Publication of information

16. The Pensions Act 2014 also requires DWP and the FCA to make regulations and rules to require the publication of costs and charges information. This is intended

to help those governing schemes to compare the costs and charges in their scheme with those in other schemes, as well as creating a more transparent market for prospective employers and members, and wider commentators.

17. The first phase of transparency will introduce new information on transaction costs into the public domain, via the annual Chair's Statements of IGCs and trustees. Workplace personal pension providers will be required to publish their IGC reports. Occupational schemes are required to provide their governance statement to members and other prescribed parties on request alongside their annual report, and a number of schemes may also choose to publish these online.

18. Feedback is sought on how to build on this to require more standardised publication of costs and charges information, and how this could be achieved. If IGCs and trustees are required to report standardised, comparable information on costs and charges as part of their governance requirements, then the simplest approach could be to require this information to be published online on scheme, employer, or provider websites. Alternatively, it may be possible to facilitate easier comparison between schemes or providers by publishing information on costs and charges, alongside other information which may aid comparison, in a single central repository. This may have the advantage of drawing together into one place all the published information about scheme costs, charges and overall performance, so decision makers, members and other commentators could see at a glance how schemes compare. The costs and complexities of each option would need to be weighed against the value of this information for different parties.

19. Responses to an earlier DWP consultation demonstrated that opinions are divided on the merits of such a system. However, feedback would be welcome on the options and feasibility of such an approach, particularly given the new duties to regulate for the publication of costs and charges information and increased expectations on trustees and IGCs.

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

# Additional governance requirements for trustees and managers of workplace pension schemes

## Wider considerations on investments

20. Following the "Implementation of the Kay Review: Progress Report" the Government committed to consulting on how the Investment Regulations refer to social, environmental or ethical considerations, to ensure that there is an accurate reflection of the distinction between financial factors and non-financial factors and whether trustees should be required to state their stewardship policy (if any) in their statement of investment principles. The DWP commenced this consultation on 27 February 2015 and will provide feedback on the outcome of this consultation following its conclusion.

21. In addition to this there have been calls from stakeholders to require disclosure of information by trustees and scheme managers about their investment functions in addition to the disclosure of charges and costs information to employers and members, where a reasonable request for such information is made by beneficiaries. It has been suggested that this should include information about:

    - the selection, retention and realisation of investments and their stewardship;
    - the exercise of rights;
    - the scheme's engagement with and selection of investment managers; and
    - the selection of and monitoring of investment funds.

    The Government has committed to consulting on these matters later in 2015 and will be seeking views then on how such disclosure could be achieved and what issues, if any will need to be addressed.

## Compliance

22. The purpose of this disclosure regime is to help trustees, IGCs, employers and scheme members to understand and take into account the transaction costs that they are incurring, when they are assessing value for money.

23. The regime needs to be established in a way that ensures that transaction costs are consistently captured, and there is no gap in the reporting of costs. This will ensure that there is no incentive for costs to be moved from "reportable" costs to

“unreportable” costs. Chapters 3 and 4 describe how transaction costs have been defined in DWP regulations and FCA rules in order to avoid inadvertently encouraging avoidance of disclosure of all relevant costs. Several respondents to previous DWP command paper consultations agreed with such an approach and mentioned that all possible steps should be taken to minimise the potential for ‘gaming’. Chapters 3 and 4 also seek views on potential methods for reporting explicit costs and the merits of reporting particular kinds of implicit costs. Once any new regulations and rules are developed and agreed, the accompanying compliance regime will be most effective if disclosure requirements are complied with in a clear and consistent manner. It will be less effective if firms, trustees or their agents behave in ways that minimise reportable transaction costs without reducing the underlying amount they are paying to transact.

24. Firms remain under other obligations under FCA rules, for example on best execution and conflicts of interest management, which govern the way in which they should transact. The intention of the transaction cost disclosure regime is to require disclosure of the costs that are being genuinely incurred, not to inhibit or prevent transacting that is beneficial to returns which ultimately benefit members. However firms may be positively incentivised to behave in particular ways because of disclosure requirements, and it would be helpful to understand what impact respondents believe these requirements are likely to have on market practices.

25. In particular, it would be helpful to understand whether behavioural influences on firms and individuals will lead them to comply with regulations and rules as intended or to find ways to transact that do not incur reportable transaction costs.

26. This call for evidence welcomes feedback on whether the regime would be strengthened by having transaction cost disclosure reports overseen in some way by a third party. For example, this could range from a requirement to have the data and / or methodology reviewed by an audit firm to the public disclosure of the calculation methodology. This could be a regulatory requirement or a voluntary standard.

**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?**

## Costs

27. Since this is a call for evidence, there is no cost/benefit analysis or impact assessment at present since this call for evidence is seeking views on the range of options available before making detailed proposals. However, such analysis will need to be undertaken in due course when regulations and rules are made by the DWP and the FCA. At this stage input would be welcome to understand what financial impact there would be on the pensions (and wider financial services) industry if the various approaches discussed in this paper were to be taken.

28. It would be helpful to understand where costs would arise, how it would be possible to quantify them, and whether any of the costs could be mitigated in any way.

    **Question 22**: **Do you have any comment on the likely costs involved in implementing transaction cost disclosure along the lines described in this call for evidence?**

# Annex 1

## Call for evidence: summary of 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?**

**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?**

**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?**

**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?**

**Question 5: Do you have any further thoughts on the analysis of transaction costs outlined in this chapter? Are there any alternative approaches to identifying transaction costs, or other considerations to take into account?**

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

**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?**

**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?**

**Question 9: Do you have any comments on the treatment of derivatives? Should the costs of derivatives be disclosed separately somewhere within the disclosure reports? Do you have any comment about the transaction costs associated with structured products?**

**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?**

**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?**

**Question 12: Do governance bodies need risk and return information to be reported alongside transaction costs, or is it sufficiently readily available to them from other sources, considering the balance of costs and benefits that such new requirements may impose? If you think risk information should be reported, do you have any feedback on the best risk measures to use when considering transaction costs?**

**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?**

**Question 14: Do you have any feedback on the reporting of the costs of securities lending, foreign exchange and related activities, and on how these should be reported? Are there any other areas or practices that you would**

**highlight where providers are imposing additional costs or generating "hidden" revenues?**

**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?**

**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?**

**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?**

**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?**

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

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

**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?**

**Question 22: Do you have any comment on the likely costs involved in implementing transaction cost disclosure along the lines described in this call for evidence?**