PENSIONS AND LIFETIME SAVINGS ASSOCIATION

PLSA RESPONSE TO THE FCA ASSET MANAGEMENT MARKET STUDY CONSULTATION CP 17/18 ON AUTHORISED FUND MANAGER GOVERNANCE

"AFM BOARDS WITH A MAJORITY OF INDEPENDENT DIRECTORS WOULD BE SUBJECT TO PROPER SCRUTINY AND OVERSIGHT"

September 2017

INTRODUCTION

We're the Pensions and Lifetime Savings Association; the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

Our purpose is simple: to help everyone to achieve a better income in retirement. We work to get more money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.

PLSA RESPONSE TO THE FCA ASSET MANAGEMENT MARKET STUDY CONSULTATION CP 17/18 ON AFM GOVERNANCE

INTRODUCTION

This consultation addresses the FCA's proposals on Authorised Fund Manager (AFM) governance – questions 1-10 in the CP17/18 paper.

Figures from the Investment Association suggest that pension funds represent 61 per cent (around £2.2 trillion) of all institutional investor assets managed by UK-based asset managers. Therefore, pension funds are significantly affected by the cost and quality of service provision offered by the asset management industry. As clients of the industry, our members are also well-placed to understand how the market could be improved to deliver better outcomes for their beneficiaries.

This submission was prepared by the PLSA, with expert input from a steering group comprised of leading pensions industry figures.

REQUIREMENT TO ASSESS VALUE FOR MONEY

Value for money proposition

We support the proposal to require authorised fund managers (AFMs) to assess and report the value for money they have provided for their clients.

While consideration of value for money ought to be a fundamental and ongoing activity for all AFMs - and already is so for some – a specific requirement to conduct an assessment will increase the visibility of client value for money as a board-level issue. Therefore, it will become a more pressing priority for AFMs.

However, the effectiveness of this requirement depends on how it is monitored and enforced. We support requirements for AFMs to report on the results of their assessments, as this will enable more effective client scrutiny. If reports are made public, this will also enable scrutiny from other interested parties, further incentivising asset managers to produce thorough and accurate reports.

It is possible to infer that sanctions on firms/individuals responsible for 'Value for Money' assessments that are untimely or fail to meet expected standards will apply in accordance with the principles set out in the FCA's enforcement handbook (in terms of proportionality and the different types of sanctions used by the FCA, for example).

However, more detailed information on this, covering how the FCA will resource and prioritise its monitoring of 'Value for Money' assessments, would provide a useful insight into how effective this requirement will be in practice.

Value for money factors

The FCA state that the following elements should be included in the AFMs' assessments of value for money:

- Economies of scale;
- Fees and charges;
- The different share classes available to investors;

- Quality of service;
- Transparency (in that the findings and consequent actions should be published).

These are all key determinants of value for money and therefore it is sensible to require AFMs to cover each factor in their assessments.

Equally, we support the proposed guidance for the more subjective category of 'quality of service.' In particular, stipulations that the AFM should explain how they have measured performance, and why the standards and metrics they have chosen are appropriate. Performance against the mission statement, including the levels of risk entailed, over the time period set out in the funds' marketing literature to clients should form a key part of this assessment.

We also recommend that AFMs should be required to report on additional criteria including:

- Whether or not they have faced any **conflicts of interests**, and the processes they have in place for managing them;
- The **core financial transactions** they have undertaken, the costs they entailed and the value they generate;
- How they ensure **fair treatment for different clients** – our members have suggested that smaller pension funds who are of less value to the AFM are not offered the same quality of service as higher value clients, resulting in proportionately higher feed for poorer service;
- How they ensure that the **culture** of the AFM is entirely focused on achieving good value for clients.

Depictions of investment industry culture aren't always fair or accurate, and worthwhile initiatives such as the diversity project to make the industry more representative of the society it serves, are already having an impact. However, certain industry practices are a source of legitimate concern to asset managers clients.

For example, pay in the industry is very high, constituting a significant proportion of the costs ultimately borne by clients, and includes significant performance incentives, despite concerns about whether the size and structure of pay awards creates extra value for clients and the kind of behaviour that it fosters. Similarly, hospitality offered and received by asset managers is a controversial topic (discussed elsewhere in the FCA's report), and can create conflicts of interest.

These examples show how the culture of the industry can have a potential impact on quality of service provided by asset managers, and the direct and indirect costs that accrue to investors. Therefore, we think that AFMs should be required to explain how they have shaped and managed their organisational culture as part of their value for money assessments.

Timeframe

Given the fundamental importance of client value for money and the fact that it ought to be a key concern for AFM boards already, we support the 12 month implementation period proposed by the FCA. This is sufficient lead-in time for the AFMs to review factors such as those suggested by the FCA as specific requirements for the assessment. It is also worth bearing in mind other changes that will be required of the industry as a result of the market study – for example, in relation to cost transparency – and ensuring that reforms are synchronised.

INDEPENDENT GOVERNANCE

Requirement to introduce independent directors

Our submission to the FCA's original consultation was supportive of measures to strengthen the independent governance of AFMs, so we were pleased to see this issue discussed in the final report of the market study.

However, we believe that in the long-term, AFM boards would benefit from a stronger independent presence than 25 per cent of board membership. If non-independent directors comprise a majority of the board and control the Chair's position, they are able to shape the priorities, decisions and direction of the AFM, even if the independent directors provide a robust challenge.

AFM boards with a majority of independent directors would be subject to proper scrutiny and oversight. They would also be consistent with corporate governance bodies and the Independent Governance Committees (IGCs) that oversee workplace personal pension schemes.

The Corporate Governance Code states that at least 50 per cent of corporate board members (not including the chair) should be independent, while a majority of IGC members, including the Chair, are required to be independent. Like IGCs and corporate boards, AFMs are responsible for significant economic entities on which the incomes and savings of millions of people depend (indeed many AFMs will be part of organisations that also operate IGCs and/or corporate boards). Therefore, they should be subject to similarly high governance standards.

While the corporate governance code is not perfect and IGCs are a recent introduction, there is a broad industry consensus that they have raised governance standards. Therefore, over the long-term we hope that the FCA will deliver consistency with these other governance regimes and by raising the requirement for independent directors from 25 per cent to a majority including the Chair.

Cost/benefit analysis

Though we have not conducted a full cost-benefit analysis of the introduction of independent directors, there are grounds for thinking that this would further support the case for a stronger independent presence on AFM boards. Figures from the IA show that there is around £3 trillion under management in pooled funds in the UK. Thus, even proportionately low levels of fund expenses create scope for significant savings (costs of 1 per cent of AUM would equate to £30 billion). Therefore, any efficiencies uncovered by independent directors would quickly surpass the cost of their recruitment. This strengthens our belief in raising the minimum number of independent directors, though we would also support a detailed FCA analysis to confirm our logic.

Defining independence

We support the FCA's proposed requirements for independent directors and note the coherence between these characteristics and some of those used to define independent directors in the Corporate Governance Code.

However, the FCA's proposed definition of independence only relates to the directors' relationships with the AFM or their parent company. The relationships with other individual directors are equally important – personal, family or business relationships with other directors would compromise independence and this should be explicitly stated by the FCA.

Similarly, long-serving directors will inevitably grow familiar with one another and with the AFM. Therefore, a 'term limit' should be introduced, beyond which the Director no longer qualifies as independent. The Corporate Governance Code specifies nine years, and again, this is a useful precedent that the FCA should follow.

Finally, diversity of thought is a critical ingredient of independent thought and the reflective, challenging culture that the FCA hopes to create on AFM boards. It is much harder for a homogenous board to achieve this. While we do not support the introduction of quotas for particular demographics, the FCA should make clear to AFMs that they will be required to demonstrate how the make-up of their board incorporates genuine cognitive diversity and a range of backgrounds and perspectives.

Implementation

The introduction of independent directors will create a need for new AFM board members with the right expertise and capabilities. Given that the individuals with these skills are likely to be in limited supply, it makes sense to permit directors to serve on more than one board. However, we believe there should be an upper limit, in order to safeguard against a small pool of the same directors serving on multiple boards. The PLSA's corporate governance code recommends a maximum of four boards for corporate directors and two for anyone serving as a board chair. We support a similar rule for AFM boards

The limited supply of directors with the requisite skills will also necessitate a considered and rigorous appointments process. It may be difficult to identify the right individuals, particularly when other AFMs are also going through the same process. In order to ensure that the right people are appointed, we recommend that the FCA allows a longer period of two years for the implementation of this requirement.