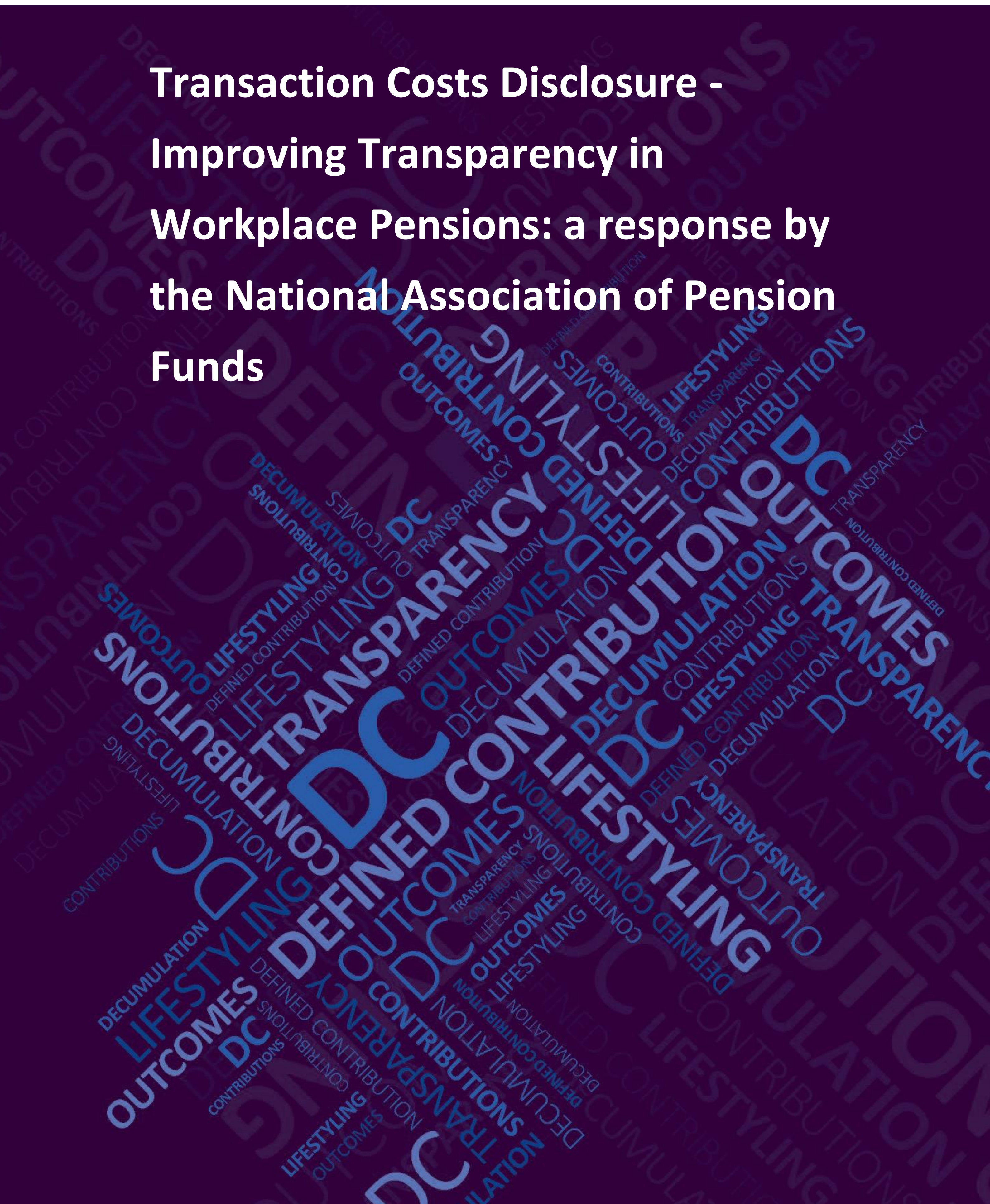
NAPF

Securing the future of pensions



Transaction Costs Disclosure - Improving Transparency in Workplace Pensions: a response by the National Association of Pension Funds

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Executive Summary

Understanding the costs associated with buying and selling investments forms an important part of ensuring value for money is secured for pension savers. Transaction cost monitoring is a further tool in defining, selecting and managing investment activity, allowing trustees and IGC members to act as informed buyers in the pursuit of their members' interests.

Schemes recognise the importance of this. The compounding of small incremental costs has a significant cumulative impact on the success of the scheme, as well as increasing member charges. Many schemes have been trying to re-assess their investment strategies to explore new ways to drive down the costs borne by members while still delivering good outcomes. This exercise has reinforced the need for more consistent and comparable information on transaction costs across the industry. In light of this, the NAPF welcomes the FCA and DWP's call for evidence.

Costs cannot, and should not, be isolated from strategy, risk and performance but the templates provided for the disclosure of transaction costs are a welcome starting point for new and innovative solutions for the wider clients of the investment management industry.

However, the NAPF believes that the templates provided by Novarca are too ambitious for the first stage of transaction cost reporting. Whilst there should be real benefits for schemes and their members of greater disclosure, we should not underestimate the scale of the challenge involved in capturing, analysing and managing all types of transaction costs. For many transaction costs there are no agreed definitions or methodologies, and many implicit costs are highly inconsistent and incredibly hard to quantify. The costs of sourcing this data also threaten to be prohibitive. For large schemes, we estimate that hiring a consultant to collate the data could cost in the region of £20,000 a year. Alongside this, there may be the additional costs of trustee resource and those involved in analysing the data. It is crucial that the ongoing costs of data collection do not outweigh any benefits gained from the exercise.

In addressing the significant potential implementation challenges and risks it makes sense to learn from those countries that have strived to establish standardised reporting of transaction costs, particularly the Netherlands. Their experience suggests that building transparency of transaction costs is a process that takes several years and the UK should not attempt to run before it can walk in this area. The NAPF is advocating a tiered and staged approach to implementation; Tiered in terms of the audience exposed to the analysis of transaction costs and staged in terms of the timing of data transparency. This would enable us to get on with the important job of disclosing and analysing meaningful, easily captured costs while allowing time to establish a sustainable and useable reporting framework for more qualitative and intangible costs.

Our response outlines some key areas of concern and makes a number of recommendations to mitigate them:

1. We should recognise that this is a journey. As such, **a pragmatic, step-by-step approach should be taken to disclosure requirements.** To enable faster implementation, the first tranche of reporting should only include quantifiable, explicit costs.
2. **To help capture implicit, harder to quantify costs, an industry working group, with DWP and FCA representation, should be established.** This would bring together

pension schemes, insurance providers and asset managers to support the development of a consistent, sustainable and useable methodology. This group would play an important role in ensuring that the costs of data collection do not outweigh the benefits. We envisage that the chair of this group would be an asset owner such as a pension scheme, trustee or IGC member.

3. **Additional disclosure requirements should be placed on asset managers to enable FCA to intervene if asset managers fail to properly provide data to trustees and other fund managers.** This would help safeguard the quality and consistency of the data disclosed and enables trustees and IGCs to do the job they have been tasked to do. This would also have the added advantage of allowing data to be used by clients of the wider investment management industry.
4. **Templates for transaction cost disclosure should be developed with DB schemes, and the wider non-pension industry, in mind. The definitions and templates for transaction cost disclosure should be workable for all funded DB and DC workplace pension schemes and for use by wider purchasers of investment management services.** While we are not advocating additional reporting requirements the principle of extending this to funded DB schemes in the future should not be ruled out as part of a tiered approach.
5. **DWP and FCA should focus on reporting to informed buyers, such as trustees and IGC members.** Transaction cost data should be made available to scheme members on request but reporting to savers is likely to be counter-productive at this stage.
6. **Transaction costs should not be included in the charge cap following the planned review in 2017.** Capping transaction costs, either by including them in the charge cap or by introducing a separate cap, could incentivise perverse behaviour and be detrimental to scheme members’ interests.

Detailed responses to the questions in the call for evidence are set out at the end of this document.

Overview of NAPF response

Introduction

1. The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector. We aim to help everyone get more out of their retirement savings. To do this we spread best practice among our members, challenge regulation where it adds more cost than benefit and promote policies that add value for savers.

2. The NAPF welcomes the Government's focus on transparency and value for money for savers in pension schemes. Trustees have a duty to act in scheme members' interest which includes making sure that investment funds are well-managed. Managing transaction costs is one part of this important job. Costs cannot be isolated from risk and performance but the collation of clear and comparable data on transaction costs would help trustees undertake due diligence and make informed investment decisions.

Background

3. The NAPF is committed to promoting good DC provision and has been leading industry action on improving governance and driving up standards. The Pension Quality Mark (PQM), a standard recognising high quality DC schemes, was launched by the NAPF in 2009. PQM READY recognises high quality master trusts with independent governance, low charges and strong communications. Alongside this, the NAPF led work to deliver the Pension Charges Made Clear: Joint Industry Code of Conduct in 2012. This sets the standard for providing clear and accurate information to employers about costs, charges and associated services when they are selecting a DC scheme.

4. In our responses to both Better Workplace Pensions consultations in 2014, we welcomed the Government's focus on improving the disclosure of costs and charges in pension schemes. Understanding the charges incurred by different investment strategies and managers is a key part of the value for money assessment that trustees undertake in securing the best outcomes for their members. The NAPF noted the lack of consistent information available to trustees in this area. However, we were clear that the benefits of disclosure can only be realised if the data provided is useable and comparable. In the absence of context, information on the investment costs being borne by members could be misleading and lead trustees and IGC members to make misguided decisions that do not necessarily offer the best value on any investment.

5. Therefore, the NAPF called on the Government to produce a consistent framework for the disclosure and reporting of transaction costs. Developing clear and consistent definitions and methodology is a vital first step. Without these structures in place, there is a risk that new requirements could expose schemes to new cost burdens with little benefit for members.

6. The gathering of transaction cost data needs to be understood in the wider context of trustee and IGC responsibilities. We have long been championing the importance of

strong governance in pension schemes. In our pre-election manifesto *Pension Possibilities,* we issued a series of recommendations to support the professionalisation of trusteeship and drive up quality of governance across DC schemes. Ensuring pension savings are professionally managed by trustee boards with the sufficient fitness, competence and expertise is critical. We called for a fundamental shift in the way pensions are regulated, switching from regulating, prescribing and guiding the activities of the trustees to regulating the trustees themselves.

7. In late 2014 the NAPF set up a working group on transaction costs to develop our understanding of the issues experienced by smaller schemes, to share best practices and to consider how disclosure and benchmarking might work in practice. The working group consists of representatives from both DC and DB schemes of all sizes, independent trustees and custodians. This group agreed that knowledge of transaction costs and their impact on investment portfolios can provide trustees, and the wider purchasers of investment management services, with meaningful insights which in turn can be used to deliver savings for members. Participants of our working group who have sought to quantify some of the costs of managing their schemes' investments reported being able to drive down costs and deliver savings for their members over a period of five years. However, some of the data on more implicit costs, such as market impact, was difficult to interpret in a way which would benefit scheme members. The output from this group has been used to inform our response to the call for evidence.

Recommended approach to improving transparency

8. Transacting is an essential part of investing and incurring transaction costs is inevitable. Trustees need to be able to understand whether their investment managers are properly managing transaction costs to ensure they are not acting as an unnecessary drag on investment performance. Dutch pension funds are already required to disclose cost information to the regulator, reporting costs that fall between 0.05% and more than 1% per annum. The release of these figures has provided a better understanding of the investment management costs incurred by pension funds, and served to highlight the benefits of cost disclosure.[1]

9. There should be real benefits for schemes and their members of greater disclosure of transaction cost data to trustees and IGCs. It is important to be clear at the start of the journey about the desired end point. The NAPF believes that the goal should be as full transparency as possible, but only where transparency affords benefits to pension savers and outweighs the cost of data collection. This should enable trustees and IGCs to understand the effect of transaction costs regardless of the asset classes and investment vehicles used in their strategy.

10. However, we should not underestimate the scale of the challenge of implementing full reporting of all types of transaction costs. For many transaction costs there are no agreed definitions or methodologies and many implicit costs are incredibly hard to

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[1] DNBulletin: Pension sector reports spending 0.53% of total investments on fees

quantify. Putting systems in place to gather data and calculate costs at different levels will take time and resource.

11. The scale of this challenge means there are potential costs and risks that will need to be managed. These risks include:
    - High costs from collecting and analysing data, which could potentially be disproportionate to the benefits of having the data;
    - The data collected proving not to be useful or reliable due to poor methodology or inconsistent collection techniques;
    - The UK setting different definitions for transaction costs to the EU that subsequently needs to be revised in light of forthcoming changes to the scope and content of transaction reporting under MiFID II;
    - Potential distortion of investment strategies or reduced investment choice, as schemes are pushed to stop investing in assets where costs are harder to measure for fear of non-compliance;
    - Potential gaming whereby investment managers or schemes change the way they invest to hide costs in more complex structures.

12. The costs of data collection need to be proportionate. Better data in this area has the potential to deliver real savings for members, but the costs of data collection need to be set against the relative value for scheme members. There will be challenges surrounding the collection and aggregation of data, which exists at a number of different levels and will need to be compiled in a meaningful way.

13. The costs involved in transaction cost disclosure will be dependent on how implementation is approached. The level of automation and the intricacy of the costs attempting to be quantified will be key factors. For large schemes, we estimate that hiring a consultant could cost in the region of £20,000 a year. Alongside this, the costs of additional trustee time to analyse the data and the potential cost of bringing on board more experienced trustees to cope with the new demands need to be considered.

14. The NAPF believes that the Government and FCA should conduct a cost benefit analysis to determine the expense incurred in capturing and reporting different transaction costs and to scope out the incremental benefits to scheme members, taking into account the additional resource factors outlined above.

15. Under the new requirements imposed by MiFID II, investment firms who execute transactions will already need to review their processes to understand whether they will need to report a wider range of transactions in more depth. A phased approach to disclosure has the added advantage of helping to avoid an excessive and potentially costly revision of transaction cost reporting in 2017. The FCA should take the time to ensure that new UK requirements dovetail with developments at EU level as far as possible, while still taking account of the particular requirements of the UK market.

16. Novarca's report for the FCA acknowledged that the reporting requirements around transaction costs could drive changes in both provider and asset manager behaviour. DWP and FCA should be wary of inadvertently pushing trustees towards a particular investment style at the expense of member returns or increased investment or operational risk. An example of this can already be seen in the application of the charge cap and the definition of property transaction and holding costs. By subjecting the

ongoing costs of managing property to the charge cap, there is a risk that such exposure becomes effectively unavailable to workplace pension investors and benefits of diversification are lost.

17. Care must also be taken to avoid creating incentives for asset managers to 'game' the system. The transaction cost disclosure requirements should look through to the underlying assets, irrespective of the legal structure and the vehicle in which they are held. In this way, a level playing field will exist, thereby avoiding arbitrage between vehicles. Equally, the costs must be capable of aggregation to the level recognized by the scheme as the "kind" in which the member invests.

18. Consistent comparison across asset classes will be key. Guaranteeing a level playing field for all investment vehicles must be at the heart of this exercise so that fair comparisons can be inferred. We feel that examples such as real estate, infrastructure and private equity should be held to the same standards as liquid strategies. Excluding an asset class from the same level of transparency would potentially disadvantage one asset class over another.

19. In their recent report on cost disclosure, CEM Benchmarking set out the difficulties of disclosing the transaction costs of private equities. They outline the complexity involved in breaking down cost structures in alternative asset classes, but offer an example of a client's detailed validation process which has helped drive more efficient investment allocation. This exercise demonstrates that attempting to create a level playing field need not impede transparency, but highlights the differences that exist between asset classes.[2] An industry-led working group would seek to bring harmony to enable fair comparisons.

20. In addressing these challenges and risks it makes sense to learn from those countries that have already implemented standardised reporting of transaction costs. In 2012, the Dutch Central Bank started implementing new standards for the disclosure of asset management costs, including transaction costs. At the beginning of this process it was noted that it would take 'several years' for all pension funds to comply with the new disclosure requirements.[3] A framework was developed to gather costs in stages, with difficult to disclose implicit costs left out of the first tranche of reporting.

21. The success of the Dutch experience enforces the idea that the UK should not attempt to run before it can walk in this area. It is the view of the NAPF that treating this as a journey would be helpful. By tackling the reporting in stages, the industry would be able to gradually develop a framework which captures meaningful transaction cost data, without sacrificing accuracy or undermining the disclosure process. This approach also has the advantage of reducing implementation costs and potentially allowing a more iterative process which will produce a better methodology.

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[2] CEM Benchmarking *The Time has Come for Standardized Total Cost Disclosure for Private Equity* April 2015

[3] Federation of the Dutch pension funds, 'Recommendations on administrative costs 2012'

22. Therefore the NAPF is urging the Government and FCA to adopt a **pragmatic, step-by-step approach to disclosure requirements.** Such an approach would have several advantages:
    - It will enable quick progress to be made on disclosing transactions costs that are easier to gather, particularly explicit costs, rather than waiting and making the best the enemy of the good. There is a large amount of data that is already held by asset managers which could be of great benefit to trustees and IGCs if it was disclosed in a consistent format.
    - Time can be taken to agree definitions where they do not exist, such as with most implicit costs, and make sure these are useful and that the costs of collecting data is proportionate.
    - As set out above, it is an approach that has been proven to work in other countries with experiences of implementing greater transaction cost transparency, particularly the Netherlands.
    - It would ensure that analysis is helpful and meaningful for DC trustees and IGCs before extending to other schemes and other audiences and would allow trustees and IGCs to determine how best to disclose to their members.

23. Consistency and clarity in the use of terminology will be critical. The pensions and investments industry needs to work together to build consensus around a common framework and shared definitions, so we can get on with implementation. Therefore **we are recommending that an industry working group, with representation from FCA and DWP, take this work forward.** This would bring together pension schemes, insurance providers and asset managers to support the development of a consistent, sustainable and useable methodology. This group would play an important role in ensuring that the costs of data collection do not outweigh the benefits. We envisage that the chair of this group would be an asset owner such as a pension scheme, trustee or IGC member.

Frameworks for disclosure

24. We welcome the templates developed by Novarca in the call for evidence, particularly as these have helped focus debate on what is achievable in the short and medium term. There are a number of welcome aspects to the Novarca analysis and templates. In particular the NAPF supports the view that:
    - Any data collected needs to be meaningful, measurable and actionable;
    - Estimated figures could be used in some instances where it is initially difficult to get real figures, particularly where this might encourage further adoption of transparency.

25. However, considering the need for a step-by-step approach, the NAPF believes that the template is too ambitious for the first stage of transaction cost reporting. Feedback from our working group suggested that:
    - Completion of the template was very complex and time consuming but might be expected to become easier over time;
    - Progress was impeded by a lack of concrete definitions and supporting information surrounding what costs entailed;
    - Once collated some of the data collected on more implicit costs, such as market impact, was difficult to interpret in a way which could benefit scheme members;

- As most historic data in this area is bundled and therefore incomparable, it was challenging to place this information in context;

26. As such, **we would propose that the first tranche of reporting should include only explicit costs, and bid-ask spreads in liquid markets where they can more easily be measured. This can be produced more quickly.** This excludes market impact, information leakage, market exposure and missed trading opportunities, but enables the collection of undisclosed revenues, exchange fees, execution/full service commission, stamp duty/transaction taxes and entry/exit fees.

27. The costs associated with FX should be captured, where they relate to an overlay strategy in the first tranche of data reporting. The consolidation of the FX activity at the instrument level, along with share class FX, will need further consideration in order to capture meaningful outcomes which help to inform trustees.

28. The NAPF believes that the issue of cost disclosure affects participants across the pension and investments industry and should be treated accordingly. Pension funds are not the sole clients of asset managers and all market players could benefit from increased knowledge on the costs of managing investments. We believe there is a responsibility for asset managers to provide data in a way that will allow schemes, as well as other customers across the industry, to compare costs and benchmark themselves against others. As a result, we strongly support the development of transparency for the benefit of all sectors, not solely pension funds.

29. In addition, we would be concerned for the wider economy if some sectors do not seek transparent reporting. Without this, costs could be transferred to sectors with less robust transparency and governance. This would not be driving consistent best practice for all.

30. The NAPF is concerned that all the regulatory requirements currently fall on schemes and pension providers. Of course, schemes will do all they can to get the data and there will be strong market pressure on asset managers to comply with requests. However, figures from investment managers may not always be forthcoming, or could be incomplete, untimely or not in the correct format. We are conscious that there are many small DC schemes, and some larger schemes and providers, which do not have the scale or means to force managers to change behaviour. A failure to collate the data may lead trustees to conclude that they should switch manager, a task that is not cheap or quick.

31. As such, **a duty of disclosure should be imposed on asset managers to help ensure the quality and consistency of the data received by trustees.** This would offer a legislative and regulatory backstop, allowing the FCA to intervene if schemes or providers are failing to meet requirements due to asset managers not providing data correctly. We base this view on three lines of argument:
    - In the absence of this requirement it could be challenging for trustees and IGCs to source data encased within funds of funds. As the key link to the wealth management industry, asset managers are often best placed to procure this information on behalf of schemes.
    - A requirement would help guarantee the consistency of data disclosed, ensuring it can be used to its maximum benefit.

- The administrative complexity involved in auditing the data produced would be reduced if asset managers were ultimately required to provide independently audited cost data to trustees and IGCs.

Who will find transaction costs data useful?

32. The NAPF believes that the primary purpose of these data should be to provide informed and professional purchasers of investment services with tools to improve transparency and knowledge of the investments they are undertaking. This will extend beyond the pensions industry.

33. In the context of the pensions industry, this will provide trustees and IGCs with the tools to better manage their members' investments. Transaction cost data is only useful to those with the knowledge or access to advice to understand what it means, and the ability to take action. We want to ensure that transaction cost data can be presented in ways that can be meaningfully benchmarked and interpreted by trustees.

34. The NAPF has supported the role of Pension Wise in delivering retirement guidance and been calling on the Government to give the Money Advice Service a clear objective to improve consumer understanding of retirement options, ensuring that the necessary information and education is delivered in close partnership with experts across the sector. Savers need to be equipped to make retirement decisions and to understand the benefits and risks of the options available to them. However, we do not believe that supplying transaction cost data by default would help to further this aim, and could indeed run counter to it.

35. Providing savers with this information without placing it in the context of risk and performance could lead them to make sub-optimal decisions. More likely, the information would baffle and disengage them. We believe efforts to promote engagement would be better focused on topics such as contribution levels and retirement options; issues which resonate with savers and have come to the fore following automatic enrolment and Freedom & Choice.

36. Therefore, at this stage, the NAPF would strongly caution against any requirements to disclose routinely transaction costs data to scheme members. Trustee and IGC chairs will be obliged to set out high-level figures on transaction costs as part of their work on securing value for money in their annual reports. This will ensure transparency and any members who are interested in transaction costs will be able to request these reports. **DWP and FCA should focus on reporting to trustees and IGCs. Reporting to consumers and scheme members is likely to be counter-productive at this stage.**

37. Information on transaction costs will be of use to market participants beyond pension scheme trustees and IGCs. Moving forward, it would be appropriate that the interests of other clients of asset managers are factored into the reporting. These will include platforms, wealth managers, insurance companies and multi-managers.

38. The NAPF believes that data will be of equal value to trustees of Defined Benefit schemes as to trustees overseeing Defined Contribution schemes. We are aware that the Local Government Pension Scheme Advisory Board (SAB) supports in principle an extension of transaction cost transparency to the LGPS. While we are not advocating

additional reporting requirements for DB schemes at this time, the principle of extending this to funded DB schemes in the future should not be ruled out.

39. Therefore, the NAPF is recommending that **templates for transaction cost disclosure should be developed with DB schemes, and the wider non-pension industry, in mind. The definitions and templates for transaction cost disclosure should be workable for all funded DB and DC workplace pension schemes and for use by wider purchasers of investment management services.**

40. Government should also take care to ensure that any new requirements do not conflict or overlap with any existing regulations or guidance in this area. For example, the LGPS currently follows CIPFA guidance (updated in July 2014) on the disclosure of investment costs and it would be important to ensure that any new requirements either build on or supersede such guidance.

Response to specific consultation 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?

Yes. In the first instance, the new requirements for transaction cost disclosure should apply only to schemes which offer money purchase benefits. This sits alongside the charge cap and new governance standards in promoting value for money for savers and these schemes are expecting to comply.

However, information on transaction costs will be of equal value to trustees of defined benefit schemes. While the NAPF is not advocating additional reporting requirements for DB schemes at this time, we believe that the definitions and templates for transaction cost disclosure should be developed to be applicable to all funded DB and DC workplace pension 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?

Bid-ask spreads represent the amount by which the ask price of the purchaser exceeds the bid of the seller. This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

In highly liquid markets, which are represented by a high number of buyers and sellers, this calculation is repeatedly updated in reflection of the volume of trading activity. In contrast, where an asset is subject to an auction process, such as real estate or infrequently traded instruments, the bid-ask spread is less transparent. In an auction process, the spread would be represented by the difference in price between the winning bid made by the buyer of the asset and the second nearest bid made. This is often an opaque number.

Our members report a range of providers who seek to identify bid-ask spread data. These range from custodians, market data consultants, brokers and technology providers, including market data providers. These organisations take different approaches to processing trading information and therefore the subsequent outputs. It has been recognised that some large consultancies employ extensive teams to model less liquid trading activity, whereas smaller consultancy organisations adopt a less quantitative approach. This results in significant deviations in outputs and different opinions over the value resulting. Our members seek a consistent methodology for the analysis of bid-ask spreads, which is consistent across asset classes.

The impact of the range in transparency and availability of the data results in different methodologies needing to be applied in order to calculate it. As such, the ability to compare across asset classes is weak.

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?

Implicit transaction costs, such as market impact, are very challenging to capture in a robust and comparable format. High quality estimates of market impact are available from brokers or specialist transaction cost analysis firms. However, there is a risk that the cost of sourcing this information would outweigh the benefits for members, especially for smaller schemes without the benefit of scale.

Members of our working group who collated this information reported that it was often difficult to see how it could be used to benefit scheme members. Moreover, if implicit costs are reported there is the potential for reportable transaction costs to be negative, which could distort the overall picture of costs borne by members.

The NAPF believes such intangible costs should be exempt from reporting in the first instance. We note that in the Netherlands these costs were initially omitted from reporting requirements and we would suggest that time is taken to agree definitions where they do not exist to make sure these are useful and the costs of collecting data is proportionate.

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?

As discussed above, it is our view that implicit costs, including missed trade opportunity costs and delay costs, should be excluded from the new reporting requirements initially. Attempting to capture and quantify too many intangible costs in the first round threatens to undermine the disclosure process and could result in missed targets. By treating this as a phased journey, we can ensure value is achieved today by capturing information of real benefit to trustees, and work towards further improvement tomorrow.

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?

We are advocating a pragmatic, stage-by-stage approach to transaction cost disclosure. Focus should initially be centred on gathering data from asset managers which offers immediate insight for trustees and IGCs, helping them better act as informed buyers in their members' interest. Once this bedrock has been established, other costs may be incorporated into the disclosure framework as consensus is developed around their definition and measurement. This would be supported by an industry-led working group, with input from the DWP and FCA.

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

The NAPF believes that DWP and FCA should focus on providing templates which capture the most helpful information for trustees and IGCs, as quickly as possible and at the lowest cost. As discussed above, there are large amounts of data that are already held by asset managers which could be of immediate benefit to trustees and IGCs if reported consistently.

It is our view that, while helpful in focusing attention and fuelling debate, Novarca's templates are too complex for the first round of cost reporting. Feedback from our working group suggested that:

- Completion of the template was very complex and time consuming but might expect to become easier over time;
- Progress was impeded by a lack of concrete definitions and supporting information surrounding what costs entailed;
- Once collated some of the data collected on more implicit costs, such as market impact, was difficult to interpret and use in a way which would benefit scheme members;
- As most historic data in this area is bundled and therefore incomparable, it was challenging to place this information in context;

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?

We consider that the future success of transaction reporting will not distinguish between different levels in the value chain. Common products and services utilised by both DC and DB schemes seek to amalgamate different investment strategies and asset classes together, in examples such as Diversified Growth Funds [known as 'DGF']. In order to report to a scheme, these products would need to consolidate reporting at the asset class level, as well as at the product level and ultimately at the consolidator level. Distinguishing between these products, asset classes or funds will limit the outcomes and trust in the reporting.

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?

Yes. The NAPF believes that pension schemes should be required to look through to the transaction costs of all listed, exchange-traded investment schemes. Our members recognise that they and the pensions and savings industry are not the sole clients of asset managers. Other parties range from insurance companies, who are likely to invest in more sophisticated strategies than retail consumers, and often invest in premiums to fund potential liabilities to wealth managers. As a result we strongly support the development of transparency occurring for the benefit of all of these sectors – not solely pension funds.

These associated industries can aid the development of reporting and transparency; leveraging their unique perspectives and reporting requirements for the potential benefit of pension schemes across the spectrum of size and complexity. Therefore, we encourage look-through to underlying investments to become a standard practice.

In addition, we would be concerned for the wider economy if some sectors do not seek transparent reporting. Without this, costs could be transferred to sectors with less robust transparency and governance. This would not be driving consistent best practice for all.

Real Estate and Property is an illiquid investment strategy. It should not be excluded from the reporting requirements. We feel that examples such as real estate, infrastructure and Private Equity should have the same standards set, as with liquid strategies. Pension schemes seek to monitor investments in the context of the markets, along with performance and risk. Excluding the likes of property from the same level of transparency will potentially disadvantage one asset class over another.

The solutions to transparent disclosure should ensure that directly held assets are not disadvantaged compared to those held as listed entities. The example we highlight is the 'holding costs' of assets. In liquid instruments, often listed, the holding costs refer to the cost of holding the 'equity' or 'debt'. This will be less than 5 bps to cover the costs of the custodian. In contrast, the holding costs of real estate are the annual maintenance costs. These vary wildly year-on-year and could disadvantage the real estate investment strategies.

A working group will seek to bring harmony to enable fair comparisons.

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?

We do not consider that derivatives should be singled out for unique reporting. Narrowing the scope of reporting will potentially impact the innovation within the industry.

Derivatives are utilised by pension schemes for a number of reasons. These include as a hedging instrument, which can be applied at the underlying instrument level, as well as for investment overlays and ultimately to aid the schemes liability hedging strategies. In addition, they can be used to replicate the underlying instrument, such as the increased use of swaps, in lieu of cash equities. Therefore, the reporting should distinguish between these different objectives.

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

We agree a principles-based approach is the right way to take this work forward. Time should be taken to develop a precise and consistent methodology for capturing and reporting transaction cost data from a set of agreed principles. We believe an industry-led working group would be an ideal forum in which to convert these principles into a workable framework.

Question 11: Should portfolio turnover rates be reported alongside transaction costs? If so, do you have any comments on the best methodology to use to ensure comparability of portfolio turnover and transaction costs?

Yes. Portfolio turnover rates are part of the wider context trustees and IGCs require to understand the value of their investments and how they are being managed. However, a number of different methodologies can be used to calculate portfolio turnover rates, and consistency and clarity will be key. We envisage a role for an industry-led working group to develop this.

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?

Transaction cost data needs to be understood in the context of risk and performance. In the absence of this backdrop, information received by trustees and IGCs will be meaningless and inactionable. However, we do not believe that extra risk and return reporting is required at this stage. Trustees and IGCs are already in possession of the relevant context of their investments as part of their wider obligations to scheme members. We would advise that the availability of risk and return information for governance is kept under review.

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?

We are clear that the purpose of collecting this cost data must be to arm trustees and IGCs with useable, contextualised information which will help them act as informed buyers. Being able to benchmark their scheme or fund's costs against other similar schemes or funds will be a key element of this. In the coming years, the accuracy of the reported costs will increase as more information is received. In the future, we would expect a more advanced benchmarking tool for transaction cost data to be introduced, with a possible role for industry for updating and maintaining it.

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?

The costs associated with FX should be captured, where they relate to an overlay strategy in the first tranche of data reporting. The consolidation of the FX activity at the instrument level, along with share class FX, will need further consideration in order to capture meaningful outcomes which help to inform trustees.

Activity undertaken by third parties, such as custodians, administrators, consultants or prime brokers should be reported to trustees based on the principals set out for transaction costs disclosures.

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?

Our working group did not discuss this issue, but the NAPF would agree that it needs to be considered and progressed.

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?

The NAPF does not believe that providers should be compelled to provide justification for periods where turnover rates do not match predictions. As best practice investment managers should provide context and narrative to support the data, but we feel that an additional requirement in this area would be unhelpful and risk straying into the territory of speculative commentary.

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

Transaction cost data should serve as an additional tool to help trustees be better informed when making investment and procurement decisions on behalf of their members. Disclosure of these costs is therefore a positive development. However, we strongly feel that capping transaction costs, either by including them in the charge cap or by introducing a separate cap, would be detrimental to scheme members' interests. Such a cap could incentivise perverse behaviour, leading asset managers to make investment decisions on the basis of regulatory compliance, not on promoting members' best interests.

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?

The NAPF believes that the issue of cost disclosure is an industry-wide issue, which extends beyond pension schemes. All market participants could benefit from knowledge on the costs of managing investments and we would like to see increased awareness across the market. As such, we are calling for an additional disclosure requirement to be placed on asset managers. This would enable the FCA to intervene if asset managers are not forthcoming in providing the data required under legislation and would help other players in the marketplace gain access to this important information.

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

We believe that the primary purpose of this data should be to equip trustees. Employers are not expected to understand investment data, and should be able to entrust responsibility for managing investment portfolios to the trustees or IGCs overseeing their scheme.

Supporting scheme members' engagement with pension saving is a key goal of the NAPF. Transparency of information is an important part of this. However, we believe that focus should remain on engaging members on topics such as contribution levels and retirement options; issues which resonate with savers and have come to the fore following automatic enrolment and Freedom & Choice.

Investment information is already supplied by trustees and IGCs as part of scheme's annual statement. Supplying savers with transaction cost data, without the appropriate context or a wider understanding of the investment issues at play, threatens to baffle and disengage them. There may be savers who would like more information on investment performance, and these individuals should be able to request the relevant transaction cost data from their provider.

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

As discussed above, trustees and IGCs are already required to provide investment management information as part of their annual scheme statement.

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?

Pension schemes are global investors and should not be deterred from pursuing a balanced investment portfolio, including overseas investments, if they are likely to offer the best returns for their members. It is not possible to introduce equivalent requirements for investment managers based abroad to disclose transaction cost data in a consistent or comparable format and we have concerns about how these requirements would operate for trustees seeking this information from overseas.

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?

The costs involved in transaction cost disclosure will be dependent on how implementation is approached. The level of automation and the intricacy of the costs attempting to be quantified will be key factors. For large schemes, we estimate that hiring a consultant could cost in the region of £20,000 a year. In addition to this will be the costs of extra trustee resource and those involved in analysing the data. It is crucial that the ongoing costs of data collection do not outweigh any benefits gained from the exercise.

Further information

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