PENSIONS AND LIFETIME SAVINGS ASSOCIATION

INTERIM REPORT OF THE FCA STUDY OF THE ASSET MANAGEMENT INDUSTRY: CONSULTATION RESPONSE BY THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

"WE ARE PLEASED THAT THE FCA HAS OUTLINED PROPOSALS FOCUSED ON BOTH THE 'SUPPLY' AND 'DEMAND' SIDES OF THE MARKET"

February 2017

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

INTRODUCTION

The Pensions and Lifetime Savings Association is 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 with over 20 million members and £1tn in assets, and over 400 supporting businesses. They make us the leading voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

Our purpose is simple: to help everyone achieve a better income in retirement.

FOREWORD

The PLSA is a strong supporter of the FCA's study of the Asset Management Market, and welcomes the findings and recommendations of the interim report.

Our members have repeatedly highlighted their concerns around the cost levels, transparency and alignment of interests along the investment chain.

The FCA study presents a number of arguments in support of some of these concerns. Many of the trends identified in the interim report imply a market that is not fully functional, competitive or subject to sufficient downward pressure on costs. These trends include:

- The consistently stable ongoing charges figure for active management.
- The high operating profit margins that the industry has enjoyed since 2010.
- The very high levels of remuneration in the asset management industry.
- The failure to achieve economies of scale for clients, as borne out by the finding that the annual management charge remains similar for funds of all sizes.
- The high ongoing charge figure for funds whose investments differ only slightly from their chosen benchmark.

It is important to note that the market is not homogenous, and that these criticisms do not apply to all asset managers. Many of those we spoke to when preparing our response noted the effect of the chosen timeframe on trends relating to the revenue and profits accruing to the sector. Quantitative easing was highlighted as an example of an external factor that might have distorted recent figures.

Pension funds invest across a wide range of asset classes, including public and private equity, and want to see high standards of disclosure across all of them, enabling comparability. Therefore, the perceived 'equities bias' of the interim report was also a concern for some of our members.

Nonetheless, the FCA's findings are suggestive of a powerful industry in which market participants may not be under sufficient pressure to control their costs. This is important because the impact of these costs can greatly diminish the incomes of savers in retirement – as demonstrated by the FCA's hypothetical example showing a 44.4 per cent difference between the net returns to a typical low-cost passive fund and a high-cost active fund with similar levels of performance.

Our response is structured into three parts, looking at the FCA proposals focused on both the 'demand' and 'supply' sides of the market, as well as on the investment consultancy industry.

We are pleased that the interim report includes recommendations covering each of these areas.

- On the demand side, the pooling of pension funds and more detailed reporting requirements of the costs that they are charged.
- On the supply side, clearer disclosure of asset managers costs and charges and a strengthened duty to act in the interests of their clients.
- For investment consultants, tougher regulation and a referral of the investment consultancy industry that serves investors to the Competition and Markets Authority

The PLSA is broadly supportive of these proposals. Our response to this consultation will explain why this is the case in more detail, and how we believe the FCA's recommendations should be implemented.

SECTION ONE: THE DEMAND SIDE – PENSION FUND CONSOLIDATION

The case for consolidation

The PLSA has been a long-standing advocate of the consolidation of pension schemes, where it can deliver better outcomes for members. Most recently, the interim report of our Defined Benefit Task Force, published in Autumn 2016, shortly before the publication of the asset management market study, concluded that the current DB system is 'too fragmented.'

The Task Force argues that 'the very large number of schemes, very many of which are not operating at a scale to be efficient, creates costs that are ultimately borne by sponsors and scheme members.' This includes costs arising because of smaller schemes' limited bargaining power – the report cites a range of international studies, as well as exploratory work regarding the pooling of local government pension scheme assets in the UK, all suggesting that larger schemes are able to achieve savings on investment management costs.[1]

The Task Force is focused solely on DB schemes, but the benefits of scale apply equally to DC, where the process of consolidation ought to be slightly simpler given the absence of complex liability issues.

[1] Pensions and Lifetime Savings Association, *Interim report of the DB Task Force*, 2016, p28

Research from The Pensions Regulator (TPR) suggests that governance issues are particularly pronounced for smaller DC schemes. A TPR survey found that compared to other types of pension fund, trustees of small DC schemes were:

- more likely to report a lack of awareness or understanding of the code of trustee knowledge and understanding (which includes requirements in relation to investment practices);
- less likely to have ever challenged the advice provided by external advisers;
- and more likely to dedicate five days a year or fewer to their trustee duties.[2]

The Governance premium

The findings of the FCA's interim report show that pooling of assets could provide pension funds with greater leverage over the asset management industry through the greater weight they would carry as higher value clients. However, greater gains from consolidation could be achieved if it also involved common governance arrangements.

Under the current system, there are not enough sufficiently qualified and dedicated trustees to manage tens of thousands of individual schemes. This results in an inevitable dilution of trustee expertise, in turn leading to a lack of intellectual parity between many trustees and their advisers and investment managers. It also makes the task of regulation much harder – the higher the number of schemes and trustees, the more difficult detailed oversight becomes.

As such, common governance arrangements, bringing pension schemes under the supervision of fewer but better qualified trustees or governance personnel, ought to be a key objective for the FCA in strengthening informed demand for asset managers' services.

But while consolidation facilitates good governance, it does not guarantee it. The general trend for larger schemes to be better governed disguises some poorly governed larger schemes (and indeed some well-governed smaller ones). If consolidation is to achieve its full potential, it will also require clearer and higher standards for pension fund governance personnel and processes, and better disclosure of governance structures.

The PLSA is currently producing a discussion paper on governance and trusteeship, examining what this might look like and would welcome the opportunity to engage with the FCA as part of our work.

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[2] The Pensions Regulator, Trustee Landscape Quantitative Research, 2015

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Mergers in DB and DC

In the DB space, the varying scale of differing schemes' liabilities make consolidation of the circa 6,000 schemes a complex process. The PLSA DB Task Force is currently reviewing how this task could be undertaken, looking at a series of models involving different degrees of integration. The Task Force will produce its recommendations in March 2017 and we would be happy to engage with the FCA to discuss our models in more detail post-publication of the report.

In the DC space, the emergence of Master Trusts in response to auto-enrolment provides a potential model for consolidation. The challenge here relates to the fact that Market Trusts are an emergent vehicle for pension saving provision, requiring new and higher governance standards. This is particularly important, given the large number of savers dependent on the largest Master Trusts.

International evidence

Here, the example of Ireland is worth consideration. A recent proposal issued by the Irish Pensions Authority sets out demanding new requirements for pension fund governance, covering individual trustee expertise and commitment; the scheme business plan; and investment strategy backed up by more active regulation. [3]

The proposal implies that schemes failing to achieve these standards would seek to join a Master Trust, which would be subject to even higher requirements. Similar policies have been implemented in Australia, where trustees are required to assess on annual basis whether or not their scheme is of the optimum size to achieve best possible outcomes for members.[4] In the Netherlands trustees are subject to interview by the national regulator, which has also directed schemes to consolidate.[5] It is worth noting that the Dutch and Australian pension systems - with fewer, larger schemes - are both ranked in the top 3 in the world by the Melbourne Mercer Global Pension Index.[6]

Conclusions for the FCA Asset Management Market Study

While some of the regulation of trust-based pension scheme governance is outside the FCA's remit, we believe that, given the relationship between governance and pension funds' difficulties achieving value from the asset management industry, the

[3] The Pensions Authority, *TPA Consultation - Reform and simplification of supplementary funded private pensions*, 2016
[4] *Final Report: Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System*, 2010
[5] Investment and Pensions Europe, *Best hands on deck: the consolidation of Dutch pension funds*, 2015
[6] Australian Centre for Financial Studies and Mercer, *Melbourne Mercer Global Pensions Index*, 2015

importance of good scheme governance should be addressed in the final report of the market study.

SECTION TWO: THE SUPPLY SIDE – ASSET MANAGER COST TRANSPARENCY AND FUND GOVERNANCE

Cost opacity

There is evidence that the capacity of pension funds to control their investment management costs is varied, and as we have already noted, the consolidation of schemes into fewer, larger funds overseen by better resourced and more experienced professionals can help to address this.

However, even our largest and most well-resourced members have expressed frustration with the asset management industry in relation to the lack of clarity of the costs and charges levied by the industry. The opacity and complexity of costs and charges varies greatly between different types of manager and mandate – for example, active or passive, segregated or pooled – but given the acknowledged impact that costs can have on returns to investors, any difficulty in accessing or understanding them is clearly problematic.

In feeding into this consultation, many of our members questioned the 'ad valorem' nature of fund management fees and noted that, aside from performance-based remuneration, the providers' costs are mostly fixed.

It is also likely that some schemes find it difficult to negotiate better value from asset managers – the PLSA's annual survey found significant variations in fund management costs across different schemes.[7] Part of this may be explained by differing investment strategies, but negotiating capacity also seems a probable contributor to these differences.

More detailed, standardised itemisation would facilitate negotiation with and comparison of asset managers, while clearer, upfront cost disclosure would enable a better impression of expected net return to beneficiaries. As such, there is a powerful case for upfront and standardised disclosure.

The 'all-in fee'

[7] PLSA, *PLSA Annual Survey 2015*, 2015

We believe that the introduction of an 'all-in' upfront fee should be limited to retail investors.

While the models proposed in the interim report would provide clarity over costs and charges, they would not be appropriate for pension fund investors. Instead we believe that the more detailed requirements in terms of disclosure and greater independent oversight of fund governance (discussed later in this response) are a more practical means of equipping institutional investors with the tools to understand costs and of ensuring internal pressure on asset managers to offer fair value.

Model disclosure code

With regard to the transparency and standardisation of costs and charges, the PLSA has fed into the Investment Association's work on a cost disclosure code. We agree that working with the industry to develop a framework is the most constructive course of action for the FCA. It is vital that whatever framework emerges is consistently applied and universally accepted as the template for disclosure and that the definitions of key terms and what should and shouldn't fall under particular disclosures is clear, in order to provide comparability. As such, there is a case for regulatory compulsion of disclosure, following thorough discussion with relevant stakeholders.

Our members report that hedge funds and private equity investment vehicles can be the most opaque around reporting, and the information they provide the hardest to assess, so it does make sense for the template to be extended to these asset classes, in order to bring about greater clarity and transparency.

The Independent Limited Partners Association (ILPA) guidelines on private equity fee reporting provide the basis for a potential template for private equity and already enjoy the support of some PLSA members.

Other costs

Across all investment managers, taxes and commissions for buying and selling assets, or fees for research or other services are reasonably straightforward to present, and the impact they have on net returns to the pension fund is relatively understandable. However, the PLSA members feeding into this consultation felt that the inclusion of 'market impact' or 'bid/offer spread' costs within transaction costs would confuse understanding of costs and charges – a simpler 'profit and loss' style account showing the various direct commissions and charges paid by the client would be clearer and enable better scrutiny of asset managers.

It is also worth noting that, as the interim report acknowledges, pay in the asset management industry is very high and that this is an important contributor to the costs accruing to pension funds. Indeed, one of the reasons that academic research has suggested for the better value achieved by larger pension funds in relation to their smaller counterparts is that they are able to reduce costs by bringing their investment management functions in-house.

Itemising the cost of staff time to a particular mandate might be too complex a calculation and not cost-effective, but the causes of high remuneration for investment professionals, whether these are truly reflective of a functional market for their services, and the consequences in terms of costs to pensions savers is something the FCA should monitor. The structure of pay for asset managers and how pay incentives affect behaviour is also an important factor in shaping the service provided to pension funds and a source of considerable concern to our members.

Pension fund costs disclosure

On corresponding disclosures of what pension funds are paying in terms of costs and charges, there would be some value in publishing this information for purposes of comparability. However, it is important to be clear about how any disclosures would be used. It is unlikely that such complex information would be understandable to the overwhelming majority of scheme members and it would therefore be of little use to them. On issues ranging from financial performance to ethical investment, it has always proved tremendously difficult to encourage savers to engage more closely in the administration of their pension fund.

It would, however, be sensible for pension funds to disclose and share scheme level costs and charges (as opposed to itemised accounts for each individual member) for comparative purposes, in order to leverage greater negotiating power or to identify where value is being achieved/lost. This information could also be useful in terms of identifying weak governance or exploitative practices, where schemes are paying significantly more than others for similar services.

Asset Manager 'duty of care'

Alongside the proposals on disclosure, the strengthened duty for asset managers to act in the interests of their clients proposed in the interim report is the other key reform relating to the supply side – the regulation of the services and information provided by the asset managers – that is of relevance to pension funds.

Ordinarily, one might expect the provider of a commercial service to routinely assess whether they are providing value for money. However, the interim report concludes that this is not currently the case. As such, there is a case for clearer requirements to do so.

The six models the FCA proposes for strengthening responsibilities in this area are not all mutually exclusive – for example, the FCA could mandate the senior managers of the Authorised Fund Manager (AFM) to consider value for money (option B) and the board to report on how the AFM has done so (option A). These measures could be undertaken alongside other moves to increase independent representation on boards (options C-E) and corresponding obligations on pension funds (option D).

These principles of clear duties, independent oversight and transparent, accountable reporting requirements at each link of the investment chain are a sound basis for any new regulations.

Conclusions for the FCA Asset Management Market Study

We are supportive of the FCA's broad proposals but recognise differences of opinion over their precise detail, particularly the template for disclosure of costs and charges. It is vital that there is a single, comparable template for disclosure, but inevitably this will need to evolve as understanding of how best to calculate and interpret costs develops. This means the use and value of the template should be regularly reviewed with opportunities made available to update the prescribed disclosures.

SECTION THREE: INVESTMENT CONSULTANTS – REGULATION AND REFERRAL TO THE CMA

Consultants' conflicts of interest

Investment consultants provide a valuable expert service to pension funds. However, our members have raised a number of potential conflicts of interests and misaligned incentives that could affect the quality of advice provided by investment consultants to their clients.

Many of the concerns cited in the report regarding consultants are shared by pension funds, including:

- consultants' incentives to report favourably on the asset managers that they recommend;
- their promotion of their own fiduciary management services;
- and the culture of hospitality involving investment consultants and those industries they work with.

Regulation of consultants

With this in mind, we are supportive of the FCA proposal to refer the consultancy sector to the Competition and Markets Authority, and to bring the sector within the regulatory perimeter.

It is striking that consultants advising pension funds are subject to far less scrutiny than the personal financial advisers who serve the retail market – even though cases of poor advice to pension funds disadvantage all scheme beneficiaries rather than just a single individual. The FCA study highlights the limitations of some pension fund trustees and the high number of very small schemes, which one can infer share similar characteristics to retail investors. Therefore, the advice they receive should be subject to similar regulation.

The consolidation of assets and governance arrangements discussed earlier in this response could address the vulnerability of smaller schemes to bad advice, but any re-organisation of pension funds will be a complex process.

In the immediate term, moves to ensure that the consultants are subject to proper regulatory oversight would do a great deal to bolster the confidence of pension savers, and enable consultants to carry out the positive role that they can play in the investment chain.

Fiduciary Management

As suggested previously, we are supportive of better disclosure of pension funds' costs and charges, as a means of providing insight into the quality of governance and value for members. This would also be the case for fiduciary managers – information on what funds are paying for which fiduciary manager and what value they are delivering would create pressure (on both trustees and fiduciary managers) to raise standards.

While some guidance on contracting and monitoring a fiduciary manager could be useful, this has to be seen in the context of the vast amounts of guidance and regulation to which pension funds are already subjected. Research from TPR has suggested that levels of awareness and understanding of existing codes and guidelines are varied.[9] The 'hard to reach' schemes who are most in need of advice regarding fiduciary managers are probably the least likely to engage with any guidance in this area.

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[9] The Pensions Regulator, Trustee Landscape Quantitative Research, 2015

Ensuring a pensions system with a manageable number of schemes, overseen by highly capable trustees would be a more fruitful way to approach challenges of fiduciary management.

Conclusions for the FCA Asset Management Market Study

The PLSA supports the FCA's proposals to bring investment consultants into the regulatory perimeter and to refer the industry to the Competition and Markets Authority. We would be happy to help the CMA with any review it undertakes.

We also support better disclosure of fiduciary management fees and performance.

NEXT STEPS

The PLSA would be very happy to discuss the positions outlined in this response in more detail, or to act as a conduit for engagement between the FCA and our members. For more information, please contact Luke Hildyard, Policy Lead for Stewardship and Corporate Governance via luke.hildyard@plsa.co.uk