THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

CONSULTATION PAPER

PUBLISHING AND DISCLOSING COSTS AND CHARGES TO WORKPLACE PENSION SCHEME MEMBERS AND AMENDMENTS TO COBS 19.8

RESPONSE FROM THE INVESTMENT ASSOCIATION

28 MAY 2019

SUMMARY OF IA RESPONSE

The Investment Association[1] (IA) welcomes the opportunity to respond to the Consultation Paper concerning disclosure of costs and charges to scheme members and amendments to the transaction costs calculations.

The IA strongly supports the need to provide complete, comparable, consistent and comprehensible information on product charges and transaction costs. In addition to engaging with regulators in the context of UK and EU reform in this area, the IA has been closely involved in initiatives to develop new reporting templates in the institutional market. In particular, the IA has always been fully committed to the work now being undertaken by the Cost Transparency Initiative, and its precursor the Institutional Disclosure Working Group. We have also developed a standardised machine-readable framework for the provision of transaction cost data to DC workplace pension schemes under the requirements of COBS 19.8.

Our key comments are as follows:

- In general, consistency of the disclosure approach for costs and charges is important. This should be accompanied by mandatory performance reporting for default strategies. Showing cost without returns does not provide meaningful information about scheme delivery.

- The proposed presentation of transaction costs in projections misrepresents the investment process by conflating product charges and transaction costs. It suggests that the investment return can be achieved without transaction costs and that these are applied in the same way as product charges. This is both incorrect and also risks actively discouraging investment in some markets on the basis that costs are higher.

- We welcome recognition that slippage cannot work in a number of markets, notably bond markets, and the solutions proposed. However, the approach on the anti-dilution levy risks compounding the counter-intuitive results being generated by slippage in equity markets. An arbitrary zero boundary will create complexity and confusion.

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[1] The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage nearly £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. More information can be viewed on our website.

IA RESPONSE TO THE SPECIFIC QUESTIONS RAISED IN THE JOINT CONSULTATION PAPER

GENERAL COMMENTS

1.1 We are highly supportive of full accountability for the costs incurred in delivering investment returns, and the associated charges levied for providing an investment or other service as part of investment delivery. The increasing tendency to bundle transaction costs and charges together risks reinforcing a view of investment outcomes and consumer harm that does not reflect the reality of the investment process. All things being equal, lower charges increase the return to investors. Transaction costs, which should nonetheless be subject to high degrees of monitoring and control, are demonstrably different in nature and we highlight why in more detail in our responses below.

1.2 Although a separate technical issue to the one consulted on in this paper, the controversy across Europe about the role of the slippage methodology illustrates the importance of a robust approach to the explanation and disclosure of transaction costs. We reiterate the need for the FCA to share more technical information about slippage to help communicate what are often counter-intuitive results produced by this methodology.

PUBLISHING AND DISCLOSING COSTS AND CHARGES INFORMATION TO SCHEME MEMBERS

Q1. DO YOU AGREE THAT WE SHOULD, WHERE APPROPRIATE, MIRROR DWP'S APPROACH IN MAKING OUR RULES?

1.3 Yes, in general we agree that FCA and DWP should maintain a consistent approach but only to the extent this is appropriate. However, we have specific concerns about the illustration of the compounding effect and raised these with DWP at the time of their consultation. In this respect we do not agree that FCA should mirror DWP's approach to the illustration of the cumulative effect over time. We set out the flaws in the approach in our answer to question 3.

1.4 In addition to disclosing costs and charges we strongly recommend requiring the investment returns of the default strategy and all other funds or strategies offered by the scheme to be disclosed on a mandatory, rather than voluntary, basis. The returns should cover the same period as the costs and charges. Performance is essential contextual information and should be presented directly alongside the costs and charges disclosures. This information will aid accountability of pension providers' for the construction and on-going performance of the default strategy and provide a valuable metric for employers looking to select a workplace pension scheme for their employees.

Q2. DO YOU AGREE WITH THE PROPOSED STRUCTURE AND SCOPE OF OUR NEW PROVISIONS?

1.5 Yes, we agree with the structure and scope of the provisions.

Q3. DO YOU AGREE WITH OUR PROPOSED APPROACH TO REQUIRING SCHEME GOVERNANCE BODIES TO PUBLISH COSTS AND CHARGES INFORMATION ABOUT A RELEVANT SCHEME?

1.6 With one exception we agree with the approach. The exception relates to the illustration of the compounding effect of aggregated costs and charges because this misrepresents the impact of transaction costs and therefore overstates the potential projected pension pot before charges.

1.7 Transaction costs are inextricably linked to the investment return generated by the transactions that take place. Without transactions there will be no transaction costs but there will be no returns either. The investors' contributions will remain as uninvested cash. The pension pot can grow no bigger than the contributions made plus the investment returns generated. To pretend that it can is misleading.

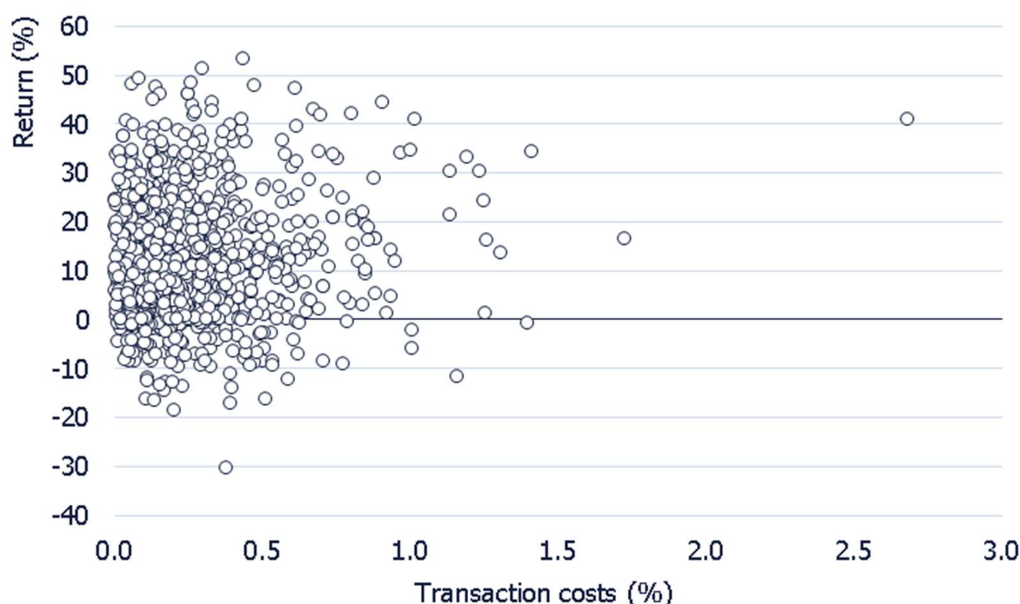
1.8 Investment managers are incentivised to maximise returns within a given objective. It is within their control to negotiate the best rates with brokers or find the best price for a security. Moreover, they have a duty to do so in order to satisfy their wider best execution obligations. This does not change the underlying reality of different costs in different markets, or of the fact that firms may decide that costs are outweighed by the investment benefits of a specific trading decision.

1.9 Transaction costs are incurred to gain exposure to the market or to change exposure in order to develop performance. A higher <u>unit</u> transaction cost will reduce the return achieved from an individual trade. However, it is not necessarily the case that higher <u>aggregate</u> transaction costs will represent a greater drag on overall performance since the primary determinant of transaction costs is the volume of trading and the positions that result from that trading determine the overall performance.

1.10 It is a fallacy that high aggregate transaction costs inevitably result in poor outcomes and we do not agree with the FCA graphic on page 18 that connects customer harm with higher transaction costs. On such logic, no investment would flow to funds investing in small companies, for example. Equally, lower aggregate transactions costs will not necessarily result in better overall returns because the reason for the lower transactions costs could be a failure to make trades which would have been performance enhancing.

1.11 An individual fund could therefore incur high transaction costs and achieve strong or weak performance. Equally, low transaction costs could produce the same variation in returns. The point is, there is no causal link between transaction costs and performance as is demonstrated in Figure 1.

Figure 1: Annualised net return against explicit transaction costs, 2012-2015



Source: IA analysis based on Fitz Partners and Morningstar data

1.12 Increasingly we are hearing anecdotal evidence of the role that transaction costs are playing in fund selection with examples of funds being de-selected because they have higher transaction costs. We have heard of consultants favouring DC solutions on the basis of lower transaction costs. This is a serious problem because the level of aggregate transaction costs is not at all correlated with returns.

1.13 In contrast, it is clear that the fees charged by the parties managing the pension scheme and investing its members' contributions can only reduce the size of the pension pot that can be achieved. It is the size of this overall reduction that the disclosures should seek to illustrate.

1.14 Consider a very simplified example of a one-off contribution to create a starting pot of £10,000. If, in the first year, this grows in line with the assumptions set out in COBS 13 Annex 2 (3% per year above inflation) the pot would be £10,300 in real terms. However, the scheme's manager charges a fee of £100 so the pot at the end of the year would be £10,200.

1.15 In this example assume that the manager invests the contribution in UK equities. Stamp duty of £50 and broker commission of (say) £5 would have to be paid (ignore implicit costs in the interests of simplicity). If the same contribution was to be invested in US equities there would be no stamp duty and the broker commission would still be £5. The required disclosures for each scenario should be as follows:

Figure 2: Illustrative example of the effect of charges

UK equity

Administration charges	£100
Transaction costs	£55

Projected pot after 1 year	
Before charges	After charges
£10,355 *(result under the proposed rule but unattainable)* £10,300 (the reality of the investment process)	£10,200

US equity

Administration charges	£100
Transaction costs	£5

Projected pot after 1 year	
Before charges	After charges
£10,305 *(result under the proposed rule but unattainable)* £10,300 (the reality of the investment process)	£10,200

1.16 The projected pots before charges are not, and can never be £10,355 and £10,305 respectively. The assumptions set out in COBS 13 Annex 2 requires that the rate of return used to create a projection must accurately reflect the investment potential of the product and must not exceed 5% (or 3% in real terms). Presenting £10,355 as a projected return is misleading because it implies that the pension pot can somehow grow by more than the maximum permitted rate of return.

1.17 This accords with the statement in the FCA Asset Management Market Study Final Report: *"We recognise that in this example, by using a gross return for the funds, transaction costs should already be captured within this. Therefore we accept that by deducting transaction costs on addition to the OCF, we double counted transaction costs for active and passive funds."*[2]

1.18 It is clear in the example above that both scenarios use identical assumptions to project identical outcomes regardless of the level of transaction costs. In practice, the existence of stamp duty in the UK, alongside many other economic factors, will be a part of an investment manager's assessment of where to allocate investments. But for scheme members it would be misleading to suggest UK equities are less attractive solely on the basis of transaction costs.

Q4. DO YOU AGREE WITH OUR PROPOSED APPROACH TO GIVING MEMBERS AND CERTAIN OTHERS COSTS AND CHARGES INFORMATION ABOUT A RELEVANT SCHEME?

1.19 Yes, we agree with the approach to giving the information to interested parties.

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[2] Para 7.8, p.45.

Q5. DO YOU AGREE WITH OUR PROPOSED IMPLEMENTATION TIMETABLE?

1.20 Yes, we agree with the proposed timetable set out in chapter 3 for the amendments to COBS 19.5.

1.21 We note that no alternative timetable is proposed in chapter 4 for the amendments to COBS 19.8 although the draft instrument implies a single date for both sets of amendments. Subject to our answers to question 6, we would encourage the FCA to permit earlier application of the amendments to COBS 19.8.

AMENDMENTS TO COBS 19.8

Q6. DO YOU AGREE WITH OUR PROPOSED AMENDMENTS TO COBS 19.8?

1.22 Overall we welcome the FCA's recognition of areas where the slippage methodology does not work. However, we think the proposed amendments serve to mask rather than fix the problem. It is inconsistent for the FCA to state that negative transaction costs can be legitimate and at the same time to propose amendments that set an arbitrary floor of zero for such costs.

1.23 Moreover, the FCA narrative suggests the solution lies in fixing negative transaction costs. This is not the case. Analysis[3] of transaction cost data provided under COBS 19.8 indicates that 244 funds report negative implicit costs whilst 148 funds (see paragraph 1.29 below) report total negative transaction costs for reasons other than the anti-dilution offset. This demonstrates that 96 funds with seemingly reliable positive transaction costs are in fact understating their data by reporting total transaction costs of less than the total of the known explicit cost components.

1.24 Therefore we do not agree with the floor created by the proposed rules in COBS 19.8.15AR(2) and COBS 19.8.22R.

1.25 Slippage is a valuable measure of trading strategies that enables firms to understand how well they implement investment decisions and achieve best execution. But it does not translate into a meaningful expression of costs borne by investors and can present an unfair, unclear or misleading view of the overall costs incurred in an investment product or service. In our response[4] to the FCA's PRIIPs Call for Input we provided evidence to demonstrate that slippage is profoundly flawed. In this response we focus on the conceptual flaws.

1.26 As a measure of implicit transaction costs, slippage attempts to capture both spread and market impact. Spread can be considered to be a real cost of trading because, if you imagine you were to buy and simultaneously sell the same asset, you would experience a loss of value. This loss is a transfer of value to the market infrastructure (brokers, market makers and so on). Market impact is fundamentally different to spread because it represents a transfer of value to other market participants (a buyer's loss is a seller's gain) and not a loss of value to the market itself. It follows that market impact is inherently part of the investment return and not a cost. Therefore, market impact is relevant to best execution as part of ensuring the best price is achieved (thereby maximising gains or minimising losses) but is not relevant to the disclosure of cost information to retail investors.

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[3] Source: Financial Express
[4] IA response to FCA Call for Input: PRIIPs Regulation

1.27 Without prejudice to our broader views on slippage as set out above, we have the following comments on the specific amendments proposed.

Anti-dilution

1.28 We agree with the proposal to require the anti-dilution benefit to be disclosed separately. In 2017 we worked together with the ABI to develop an automated delivery mechanism to facilitate compliance with the FCA's newly made rules in COBS 19.8. This mechanism, known as the DC Workplace Pensions Template (DCPT)[5], requires the anti-dilution benefit to be disclosed separately. Therefore this disclosure aspect of the proposal brings COBS 19.8 into line with existing market practice.

1.29 We do not agree with the part of the proposal that limits the amount of the anti-dilution benefit that can be taken into account because it fails to address the flaws in the overall approach. Analysis[6] of transaction cost data provided under COBS 19.8 indicates that 250 funds have negative total transaction costs, and that 102 of these (41%) have an anti-dilution benefit that is greater than the total transaction costs before taking account of the benefit. There are 148 funds (59%) with negative transaction costs for reasons other than the anti-dilution offset. Therefore the proposal will serve to reset the transaction cost number for less than half of funds currently showing negative costs without addressing the underlying issues with slippage. For the remainder, it is unclear what the FCA expects where transaction costs are already negative before taking account of the anti-dilution offset – should the offset be applied to make the result a larger negative figure or should a negative offset be created?

Calculation of transaction costs of bonds

1.30 We agree with the proposed interpretation of arrival price for bonds and we believe it is consistent with the PRIIPs RTS. This is essential to ensure firms can have a single approach to the cost calculation across all products. We would recommend finessing the condition at the beginning of the rule in COBS 19.8.15AR to accommodate situations where two-way prices are not available from multiple counterparties. For example, we understand that many of the platforms facilitating electronic trading of bonds cannot cater for two-way quotes. In such circumstances firms will need to use other sources of market data, such as screen prices, to determine the price for the other side of a trade.

COST BENEFIT ANALYSIS

Q7. DO YOU HAVE ANY COMMENTS ON OUR COST BENEFIT ANALYSIS?

1.31 The cost benefit analysis is based on the premise that reducing costs and charges will allow scheme members to enjoy higher net returns on their pension pots. This is true for charges, all else being equal, but is wrong for transaction costs. As we set out in our answer to question 3, there is no correlation between transaction costs and returns. Indeed, Figure 1 shows that the best and worst returns were achieved by funds with very similar transaction costs.

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[5] DC Workplace Pensions Template (DCPT)
[6] Source: Financial Express