

FCA Consultation CP16/30: Transaction cost disclosure in workplace pensions

Hymans Robertson LLP's response to the FCA CP16/30 October 2016 Consultation: "Transaction cost disclosure in workplace pensions".

Hymans Robertson LLP is an independent consultancy specialising in pensions. We provide actuarial, benefits, investment and risk management consultancy to private and public sector clients across the UK. We also provide actuarial and investment advice to financial institutions.

Summary

We are broadly supportive of the proposals for improved disclosure of transaction costs in Defined Contribution ("DC") workplace pensions.

Placing a duty on fund managers and product providers to collate and supply information on transaction costs is essential to completing the annual governance statements by the Chairs of Trustees of occupational DC pension schemes (including Master Trusts) and provider's Independent Governance Committees. We believe it is right that disclosure should focus on supplying information to Trustees and Independent Governance Committees, as most scheme members are in a default arrangement and will rely upon the Trustees or IGCs to look after their interests in this area.

The "slippage cost" approach strikes a fair balance between capturing transaction costs and excessive complication, although some further refinement of the proposals is needed for investments in property while bond markets lack the transparency of equity markets. We also feel that further guidance on the format in which transaction costs and its constituents are presented would be desirable, particularly to ensure consistent disclosure in Chairs' annual governance statements.

Nevertheless, for many DC members the impact of bid-offer spreads on the unit pricing of "single-swinging" priced funds, which are widely used in UK DC schemes, will be more significant than slippage costs at an underlying fund portfolio level. So, we believe that there is also a need for more disclosure of hidden entry/exit costs, such as bid-offer spreads, and the operation of single-swinging priced funds to both Trustees/IGCs and members.

Our main concern is, however, that the time fund managers and platform providers need to set up efficient reporting processes should not be under-estimated and that the cost of doing so will be passed on to members.

Responses to consultation questions and observations on supporting comments

Q1: Do you agree that our proposed rules will enable information on transaction costs to reach governance bodies? If not, what alternative(s) would you propose?

We agree that the proposals will enable information to flow from those who hold it to those who need it. Our main concern is that automating the reporting processes to ensure that information can be supplied on a timely basis may take some time to implement due to complications such as:

- Where a DC platform provider operates bespoke "fund of funds" consisting of funds from several fund managers, where each sub-fund is also a fund of funds;
- Where trading is carried out centrally, perhaps globally, across a large number of funds and there are several share classes for each fund; and
- For bond funds where market making is conducted at arms-length from fund managers and there is a case for greater transparency at a market making level.

Q2: Do you agree with the approach set out for calculating transaction costs? If not, what alternative(s) would you propose?

We think that the “slippage cost” approach strikes a fair balance between capturing the majority of actual or potential transaction costs and excessive complication which would cloud the overall picture. We do, however, believe that further work is needed on costs for bond, derivative and particularly property markets to ensure consistent comparisons with equities.

We support separating entry/exit costs which are investor driven from the ongoing costs of managing a fund’s underlying portfolio of assets where trading activity is under the manager’s control. Although it should be borne in mind that inflows and outflows are often used to manage changes in a fund’s investment strategy which would otherwise have impacted portfolio level transaction costs if there had been no cash-flows. There is a case for reporting on cash-flows and changes of investment strategy as part of the accompanying contextual information.

“Single-swinging” priced funds (where all trades on a day take place at either the bid or the offer price depending upon a fund’s net cash-flow) are prevalent in DC both among fund managers and platform providers’ “wrappers” of the underlying managers’ funds. This approach can have a material impact on the investment performance actually experienced by members when a fund’s pricing swings between bid and offer – either during a performance measurement period or between when contributions were invested and disinvested. So, as only one unit price is published for single-swinging priced funds, we believe it is important that the impact of price swings (and other forms of hidden dilution levies) as part of the fund level entry/exit costs is disclosed alongside portfolio level slippage costs. We also feel that more should be done to explain this aspect of unit pricing and its potential impact on members’ DC values.

We agree that the costs of securities lending should be included in transaction costs as the benefits of securities lending will be reflected in investment performance. However, it is important that the costs of securities lending are provided in context, not just of investment performance, but also including information such as the basis in which income is shared together with the costs of administering the facility and providing indemnity against non-recovery of assets.

Q3: Do you agree with the proposals in this chapter? If not, what alternative(s) would you propose?**Equities**

We would expect that, in practice, fund managers will tend to batch trading orders as part of the routine management of a fund’s portfolio of assets unless there is a pressing market driven reason to trade outside the manager’s customary cycle.

Bonds

As mentioned in response to Q1, we do have a concern that the arms-length pricing by market makers may mean that bond prices, especially when no trades are taking place, may be less robust and timely than for equities.

Currencies

We agree with the proposed use of a consolidated exchange rate.

Derivatives

We agree that the costs of derivatives should be measured as derivatives may constitute a significant part of some funds’ assets or be used to implement changes of investment strategy. It is important that fair values for non-linear derivatives are calculated on a consistent basis to facilitate comparisons and so we would like to see fund managers set out the methodology used when they have applied market conventions.

Property

As we have seen recently with either fair value adjustments or trading restrictions temporarily placed on property funds, asset valuations for illiquid assets such as property are subjective. A further issue for DC is that the values being traded are often small and so are met out of funds' cash-flows (investor inflows and outflows as well as rental income) rather than buying or selling assets. As a result, while transaction costs in equity and bond funds can be linked to specific sales and purchases of portfolio holdings, there is a case in property funds for using a broader based and longer-term average of trading activity (as long as the basis and any intervening trading restrictions are disclosed) - even if it means that the quoted costs are less representative than those of other asset classes.

Q4: Do you agree that our proposed rules will enable pension arrangements and funds that invest in other funds to amalgamate the total transaction costs from underlying funds?

Given the widespread use of fund of funds and multi-asset funds in DC, we think it is essential that costs are amalgamated at a fund level (with a look-through to the underlying funds) rather than the present asset class basis under the Investment Association's "Level Two" Disclosure Code.

Nevertheless, we would not under-estimate the work and consequent costs involved in automating the reporting process at both the fund managers and DC platform providers so that information can be supplied promptly and accurately on request. Fund manager trading often takes place at a conglomerate level across several funds and share classes of the same fund, while the management of fund of funds may be undertaken by a DC platform provider with inputs from several fund managers – so both fund managers (providing the base portfolio level costs) and platform providers (collating and apportioning costs for each fund of funds) would have work to do.

We do have a concern that the costs of this additional work will impact members. For instance, leading to platform providers increasing charges for operating bespoke blended fund of funds designed to meet the needs of a specific DC scheme's membership.

We also feel that some guidance on the format of disclosure by fund managers and platform providers would be desirable to avoid inconsistencies in presentation leading to difficulties in interpreting the results by Trustees and IGCs.

Q5: Do you agree that transaction costs should be amalgamated on the assumption that underlying funds incur them evenly over a reporting period? If not, what alternative solution(s) would you propose?

We agree that costs should be amalgamated and, to avoid complication of limited value, it should be assumed that costs are incurred uniformly. However, we would hope that fund managers will provide supporting commentary on significant changes in investment strategy and market conditions during a reporting period to give a clearer picture of the incidence and causes of transaction costs – especially for where significant investment or disinvestment takes place part way through a reporting period.

Q6: Do you agree that the approach set out in this chapter is adequate to provide governance bodies with sufficient information to assess transaction costs? If not, what alternative(s) would you propose?

We do not believe that the present Investment Association Level Two Disclosure Code provides meaningful fund level information on stockbroker commission and withholding taxes because of the prevalence of fund of funds and multi-asset funds in DC workplace pensions. As a result, we would like to see a breakdown of all the readily identifiable costs within the overall figures.

As discussed in Q2, we would support separating entry/exit costs driven by member actions from the costs of trading in a fund's ongoing portfolio of assets which is under the fund manager's control. However, it is important that there is commensurate disclosure (including contextual information) of both entry/exit costs as well as transaction slippage costs at a fund portfolio level.

While providing information on request is reasonable, we imagine that it would be more efficient for both fund managers and DC platform providers, as well as more convenient for Trustees and IGCs, if reporting took place as a matter of course. By the same token, it would be in the interests of the fund managers and platform providers to produce information in a consistent format, including contextual information on funds' characteristics (such as investment objectives) and management (such as trading volumes, changes of investment strategy and unit pricing basis) at the same time to support the interpretation of the information by its recipients.

We support the provision of information on administration costs. This information is rarely divulged by providers of bundled/full-services DC products at present. Potential benefits of greater transparency of administration costs could include:

- The Trustees of bundled schemes being better placed to consider the administrative aspects of the Pensions Regulator's DC Code of Practice 13 (especially when a provider is being selected);
- Any cross-subsidies between funds, and the members who are invested in them, would become clearly visible – such as for legacy bundled Additional Voluntary Contribution products using a flat percentage Annual Management Charge; and
- Greatly assist in comparisons of Value for Members (in accordance with the 2015 Regulations) between providers' bundled full services DC products (for contract and trust based schemes) against unbundled occupational schemes using third party administrators.

We feel that annual reporting should be seen as a minimum. The provision of quarterly transaction costs and entry/exit costs alongside Total Expense Ratios, to correspond with the minimum frequency of reference points for charge cap monitoring purposes, would facilitate regular monitoring of Value for Members as encouraged in the Pensions Regulator's July 2016 Code of Practice 13.

Q7: Do you have any comments on our analysis of the costs and benefits of introducing rules on transaction cost disclosure?

We would agree that the introduction of a standardised basis for reporting transaction costs should be more cost-effective for fund managers and platform providers than the present ad hoc arrangements as well as providing better and more consistent information for Trustees and IGCs. Nevertheless, we do have a concern that the costs of this additional reporting will ultimately impact members.

However, while it is important that Trustees and IGCs receive and understand this information, we wonder how much impact it will have on the level of transaction costs in a global trading market. We might speculate that this added insight into transaction costs might instead lead to moves towards more tax transparent fund vehicles and/or moves away from markets where withholding taxes or initial investment costs account for a significant proportion of the overall transaction costs (such as Stamp Duty Reserve Tax in the UK).

Enquiries

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