UK FCA publishes interim report of asset management market study

The FCA has issued its long-awaited interim report on the UK asset management sector. The FCA identified a number of issues and proposed a wide-ranging package of remedies, including proposals aimed at increasing transparency around charges and fees and improving fund governance. The FCA is also consulting on whether to refer the investment consultancy market to the CMA for an in-depth investigation.

Background

The interim report, which was issued on 18 November 2016, follows a market study launched in November 2015 and the FCA's review of competition in the wholesale sector in 2014.

The FCA has highlighted a number of issues, including weak price competition within the asset management industry, lack of transparency around charges and fees, the strength of fund governance, the ability of asset managers to control the costs of ancillary services and the role of investment consultants. In order to address these issues, the FCA has proposed a "significant" package of remedies on which it is now consulting and seeking views by 20 February 2017. The FCA's final report is expected in the second quarter of 2017.

Price competition and cost control

The FCA considers that there is weak price competition for actively managed funds, and that this has a material impact on the returns of investors through their payments for asset management services. In particular, the FCA has found considerable price clustering for active equity funds (with many funds priced at 1% and 0.75%), and that asset managers have consistently earned substantial profits across a six year sample.

The FCA also considers that in many segments, weak pricing pressure is associated with weak cost control. While asset managers tend to be good at managing charges which are straightforward and inexpensive to control (for services such as safekeeping of assets and many other ancillary services), the FCA considers that they are less good at controlling costs for services where it is more expensive to monitor value for money (such as how well executed trades and foreign exchange transactions are).

The FCA considers that there is stronger price competition for passively managed funds, although it has found some examples of poor value for money in this segment.

Investor outcomes and transparency

The FCA's view is that overall, actively managed funds do not outperform their benchmark after costs and that both fund investment objectives and fee breakdowns tend to be unclear to investors. This outcome seems to be worse for funds available to retail investors, which do not outperform their benchmark and is only marginally better for institutional investor products whose returns are not significantly greater than the benchmark.

Whilst there has been improvement on transparency (particularly following the introduction of the ongoing charges figure), the FCA considers that there is room for improvement. Some charges, such as transaction costs, are not disclosed to investors, or are estimated in advance, so risk being inaccurate.

The interim report also raises specific concerns relating to how absolute return funds (funds that aim to deliver a positive return) report their performance and the fact that some of these funds charge a performance fee even where performance is below the fund's stated performance objective.

Key issues

The interim findings include proposals to:

- strengthen the duty on asset managers to act in the best interests of investors
- increase transparency and standardisation of costs and charges and require clearer communication of fund charges, including for institutional investors
- introduce an all-in-fee so that investors can understand all fees and charges being paid by a fund
- introduce measures to help retail investors identify the most appropriate fund
- refer the investment consultancy market to the Competition and Markets Authority (CMA) for in-depth investigation

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In light of this, the FCA study focuses, in particular, on clearer communication of fund charges and their impact at the point of sale and in ongoing communication to retail investors. Many of the FCA's proposed changes are aimed at making all charges taken from the fund more visible and impose more discipline on overspend against estimates.

The FCA is also clear that it is not just concerned with retail investors, and can see merit in requiring increased transparency and standardisation of costs and charges information for institutional investors (particularly taking into account difficulties pension trustees have had getting information on transaction costs). For example, for segregated mandates the FCA notes that there is no consistent definition of the annual management charge, with managers including different items within this charge.

Interestingly, the FCA notes that information about charges is often unclear for those investing through more complex fund structures such as hedge funds and private equity funds. Although PE funds were not in scope of the market study, the FCA has received comments that this is a particularly opaque part of the asset management industry, and that it will consider whether any remedies should apply in that part of the sector.

An all-in-fee?

A key proposed remedy is an "all-in-fee" approach to quoting charges, so that investors in funds can easily see what is being taken from the fund.

There are four possible ways, set out in the interim report, in which the all-in-fee could be implemented

- the current ongoing charge figure (OCF) could become the actual charge taken from the fund, with the asset manager covering any variation between the estimated OCF and the actual charges. Transaction costs, such as stamp duty and dealing commission, which are not included in the OCF, would not be included in the actual charge taken from the fund
- a similar approach with the OCF being the actual charge, but with the asset manager providing an estimate of any implicit or explicit transaction costs
- a single charge including all transaction costs, but with an option for 'overspend' if additional trading is deemed necessary
- a single charge with no overspend option, so the asset manager would have to fund any difference between the forecast and actual trading costs, which would include transaction costs.

This focus on introducing an all-in-fee is very much in-step with the direction of travel under EU regulation on increasing the transparency and simplicity of charging. There may, however, be potential unintended inflationary or other consequences of a single charge approach.

"Closet tracking"

The FCA invites responses on how "closet tracking" should be defined. The study looks at partly active funds priced at 'active' levels and how such products are unlikely to generate value for money for investors. Within this, the FCA has been looking at tracking error of funds, and how this can be used to distinguish between active and passive funds, but invites further feedback from the market on the correct approach.

Acting in the best interests of investors

The FCA's view is that Authorised Fund Managers ("AFMs") do not robustly consider value for money for fund investors. Whilst AFM boards have duties to act independently and in the best interests of investors, the FCA's view is that they do not currently have an explicit and well defined obligation to seek value for money.

In response, one of the FCA's proposed remedies is placing a duty on asset managers to assess how their funds deliver value for money to investors, including transaction costs (which could result in AFMs performing an annual arm's length reassessment and, where appropriate, renegotiation of management agreements with the asset management company. They may also be required to make public an annual report detailing activities in reassessing and renegotiating contracts).

There may be variation on this outcome. The FCA will look at whether to replace authorised fund manager boards with majority independent fund boards, similar to the US Mutual Fund structure, or impose greater duties on trustees and depositaries to assess whether the fund manager is delivering value for money.

For OEICs and Unit Trusts, the FCA is considering keeping existing governance structures with a clarification of duties or wrapping this into requirements on senior managers when the Senior Managers and Certification Regime is extended to asset managers.

The FCA believes similar standards of governance should apply to UCITS and AIFs (if the AIF is distributed to UK retail investors).

Measures to help retail investors identify the most appropriate fund

With a view to best buy lists and fund ratings, the FCA found that in recent years the funds on the list, while outperforming those not on the list, have not outperformed their benchmarks. In particular, the FCA is critical of the inflexibility of benchmarks for actively managed funds, and is focussed on the need for parameters to be set against the stated investment policy of the fund.

The FCA will look at requiring asset managers to set clearer and more specific fund objectives, providing a timeframe over which performance should be assessed, providing

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information which allows investors to assess whether performance objectives are being met, including disclosing managers' benchmarks.

That might include requiring asset managers to be more specific with investors by clarifying an upfront objective and tracking performance against that objective over an appropriate time period. The FCA will also look at setting expectations on using benchmarks, particularly when benchmarks are used to trigger performance fees.

The FCA also states that retail investors have not benefitted from economies of scale by pooling their money together through platforms and raises concerns about the value provided by platforms. The FCA proposes further work in this area for the future.

"Switching"

The interim report notes that, in order for there to be effective competition in the sector, investors need to be able to compare products and be able to switch to alternative products if they so wish. The FCA identifies several barriers to switching, such as the imposition of charges, lengthy administration processes and a reluctance to crystallise a loss or cut short a recommended holding period. This is compounded by the fact that it can be difficult for investors to know in the first place whether they would be better off switching. The result, according to the interim report, is that many investors, particularly retail investors, remain in persistently poor performing funds. On the other hand, the FCA notes that asset managers find it difficult to switch investors into new share classes, which would be in the best interests of the investor, because many investors do not respond to communications from the asset manager to give the necessary consent to switch product.

The FCA proposes remedies for some of these issues, on which it is seeking feedback, such as making it easier for retail investors to move into better value share classes in certain situations. The requested feedback includes an estimate of the cost of moving investors to cheaper share classes and an assessment of any unforeseen consequences of the proposed remedies around switching.

"The recurring theme in these proposals is investor protection, through increased transparency."

Investment consultants

The FCA has found that investment consultants undertake valuable due diligence and their ratings influence which managers are chosen by institutional investors, but that the ratings do not appear to help institutional investors identify better performing managers or funds. The FCA also considers that there are conflicts of interest in the investment consulting business model which require further scrutiny.

The FCA has provisionally decided to refer the provision of investment consultancy services to the CMA for an 18 month market investigation. The FCA considers that the CMA would be best placed to explore what impact the difficulties of assessing the quality of investment consultancy advice has on competition between investment consultants, the advice they offer, and ultimately, the returns investors receive.

The FCA notes that the asset allocation advice provided by investment consultants and employee benefit consultants is not regulated by the FCA, so it is not able to set performance standards or assessment criteria. The FCA is therefore also considering recommending that HM Treasury brings the provision of this advice within the FCA's regulatory perimeter.

Further work on distribution in the retail market

The FCA is considering undertaking further competition work, outside the asset management market study, in relation to retail distribution of funds. In particular, the FCA will consider further the impact financial advisers and platforms have on value for money.

Comment

The interim findings recognise that the UK's asset management industry is the second largest in the world, managing almost £7 trillion of assets, and that over three quarters of UK households with occupational or personal pensions use the services offered by asset managers. The FCA has outlined a number of issues in the sector and has proposed a package of remedies which are mainly focussed on increasing transparency.

The Chief Executive of the FCA, Andrew Bailey, commented that the FCA wants to see greater transparency, so that investors can be clear about what they are paying, the impact charges have on their returns, and asset managers ensuring investors receive value for money through pursuing energetically their duty to act in their customers' best interests. The remedies proposed by the FCA aim to achieve those outcomes.

The provisional decision to refer the investment consultancy market to the CMA for an 18 month investigation marks the first time the FCA has proposed to make such a reference. The FCA's consultation period, for both its proposed remedies package and proposed reference to the CMA, runs until 20 February 2017, representing a longer consultation period than for previous market studies. Following the consultation, the FCA will consider further the issues it has identified, taking into account any further evidence or views from market participants, including asset managers' assessment of the proposed remedies.

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