When will transaction cost transparency arrive?

LCP DC Investment Survey 2018

August 2018

Introduction

Welcome to our 2018 survey of DC asset managers and pension providers

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As I am sure you don't need me to remind you, the last few years have been hectic for those of us with responsibilities for DC members' futures. We've seen seismic changes with the introduction of auto-enrolment and freedom and choice, as well as greater involvement from The Department of Work and Pensions (DWP) and the Pensions Regulator (TPR), notably with the introduction of the annual chair's statement and the subsequent regulatory updates designed to increase the transparency of costs and promote greater trustee accountability.

While these improvements are widely welcomed by the industry, they also present challenges.

Asset managers and providers have experienced greater scrutiny, and are under pressure to offer access to funds that really deliver, while also remaining value for members' money. The requirement for all fund managers to disclose transaction costs in a clear and meaningful way came into effect early in 2018, although at the time of writing, managers are still experiencing a few teething problems in doing so.

Against this backdrop, we wanted to understand more about how managers and providers are adapting to the requirement to be clearer about the costs and charges involved in pensions investments.

I'd like to thank all who participated in this survey, and for allowing us to share this insight with you.

Who took part?

20 DC asset managers where our clients are invested

5 of the largest DC pension providers

Key findings

Over 50%

of respondents will be able to provide members with a whole year of transaction costs, in the "slippage cost" format, in time for chair's statements to be signed off for the Report and Accounts for 30 June 2018.

Nearly 50%

envisage some problems with providing data for some asset classes in self-select ranges, meaning the information might not be there for all members

80%

of providers have internal checks for reasonableness of transaction costs

How are managers adapting to the legislation?

Transaction costs have recently come under the spotlight as a result of two new legislative requirements that impact both DC managers and trustees.

The new legislation is designed to generate comparable information from managers and increase member awareness of the costs they are paying from their pension pots, and to help them understand the impact these costs can have on their retirement savings.

These two new requirements are:

1. for those who manage funds to provide transaction cost data for the day to day management of the funds, using a uniform calculation methodology (called the slippage cost methodology). The FCA put this into effect from 3 January 2018[1]; and

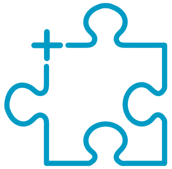
2. for trustees to use this information to provide members with an illustrative example of the cumulative effect, over time, that scheme specific charges (which incude costs such as investment manager fees, administration costs **and** also transaction costs) have on projected DC pension pots. The DWP introduced this for all annual chair's statements which have a year end after 6 April 2018[2].

These requirements build on initial legislation from April 2015 for schemes to "include transaction costs as far as you are able" and to assess their value for money as part of the annual chair's statement. However, most DC trustees have been unable to do this thus far, meaning members, and trustees, have not had full details of the costs of the funds used by their schemes. Some managers did not disclose transaction cost information. For those that did, many different calculation methodologies have been used resulting in inconsistent figures from one manager to the next.

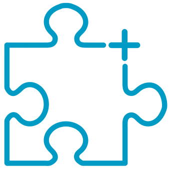
However, whilst there is now clarity on how to calculate costs, there has been very little progress made in trustees obtaining and assessing these costs since the data is still not yet available. We understand from fund managers that components of the slippage cost methodology have not previously been monitored by them, and therefore recording this data requires managers to fundamentally rebuild their internal technology, a task for which they've had less than a year to complete.

The delay in managers being able to provide the data could further damage engaged employees' confidence in pensions, if communicated incorrectly.

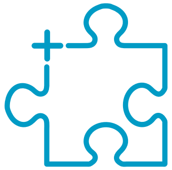
As we see it, there are three questions that need to be answered before DC schemes will be in a position to provide members with transaction cost data – the final piece of the jigsaw in providing members with full transparency of the costs paid from their pensions.



When are managers and providers going to be in a position to provide transaction costs?



Will there be transaction cost data for all funds?



Is there any confidence that these costs are being verified and audited?

1. Transaction cost disclosure in workplace pensions, Financial Conduct Authority
2. Cost and charge reporting: guidance for trustees and managers of occupational schemes, Department for Work and Pensions

When are managers and providers going to be in a position to provide transaction costs?

September 2017

FCA confirms it will be compulsory to produce transaction costs using uniform methodology.

03 January 2018

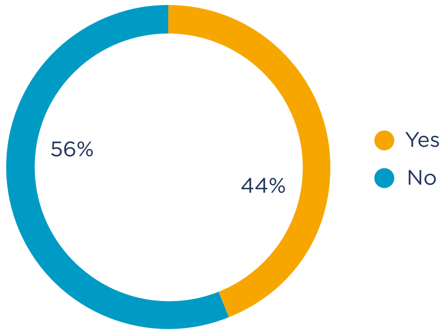
Transaction cost regulation comes into effect.

31 March 2018

Over 50% of respondents do not believe they will be in a position to provide transaction costs in time for inclusion in March 2018 Year End statements.

Investment managers' first priority is to provide transaction costs covering the first quarter of 2018. Pro-rating these costs will allow schemes to provide members with a proxy annual cost figure.

Will you be able to provide transaction costs in time for March Year End statements?

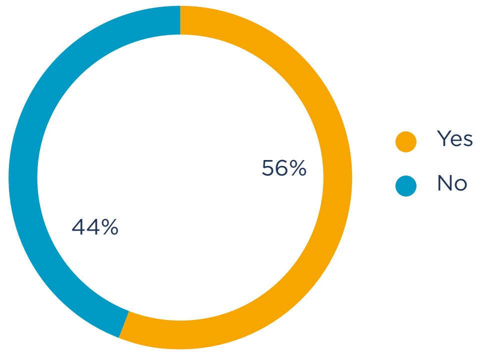


30 June 2018

Over half of respondents believe that by the time June Year End chair's statements are due they will be in a position to provide transaction costs for the whole year.

Once managers have provided a single quarter of transaction cost data for March Year End statements, there is the expectation that, for June Year End statements, they will calculate a figure which covers the whole annual period.

For June Year End statements, will you be in a position to provide transaction costs for a whole year?



2019

One year on from the new regulations, will we have business as usual...?

Will there be transaction costs data for all funds?

Nearly half of providers and managers envisage some problems in reporting transaction costs for certain asset classes

While the majority of DC savers are in default investment strategies, the requirement for managers to disclose transaction cost data for all asset classes means disclosures also apply to asset classes traditionally offered as self-select options, such as property.

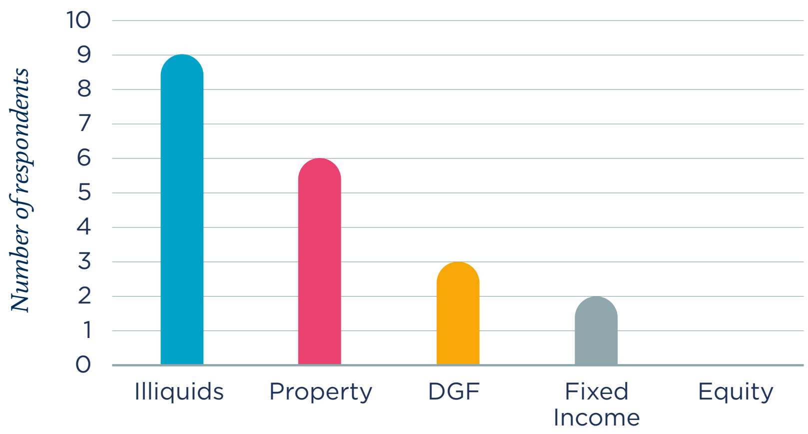
However, around 45% of respondents envisage problems in reporting transaction costs for some asset classes in a timely fashion, with illiquid asset classes, such as property - consequently some diversified growth funds (DGFs) - being the main asset classes with issues, as illustrated below.

This could be a major stumbling block in providing members with a comprehensive comparison of fund transaction costs.

Focus on illiquids

Whilst illiquid assets are a relatively new concept for DC, more schemes are now including a broader range of illiquid assets than just property. Problems in providing transaction cost data on these assets could impact progress in their adoption.

Which asset classes or funds do you envisage problems in reporting transaction data in a timely fashion? (tick all that apply)



Focus on property

Property funds are a mainstay self-select option for most DC schemes which also typically have larger transaction costs. If issues arise/persist in disclosing property transaction costs, it could fundamentally reduce confidence in the regulatory cost regime, as it would no longer offer members a comprehensive comparison of transaction costs across the range of funds offered to them.

Focus on DGFs

DGFs are a fundamentally important asset class for DC, being used by schemes in both the accumulation and de-risking phase of default lifestyles as well as on a self-select basis. Therefore, it will be key for many schemes to have complete cost data for this asset class.

Is there any confidence that these costs are being verified and audited?

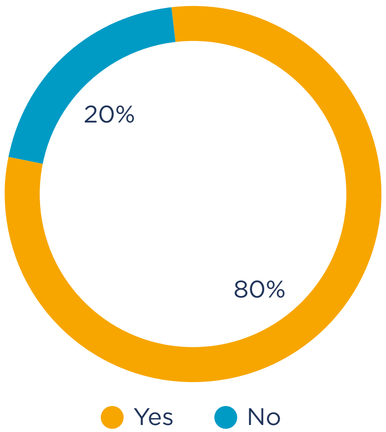
DC platform providers are beginning to take an active role in offering independent verification of costs

When publishing transaction cost data that is often derived from complex internal manager models, trustees will be pleased to hear that many platforms are willing to take an active role in ensuring some basic checks have been conducted to confirm that the costs reported are reasonable. This lends credibility to the data included in the statements and provides trustees with more assurance that cost comparisons between similar funds are on a like-for-like basis.

80% of our surveyed providers have internal procedures to check for the reasonableness of the magnitude of reported transaction costs.

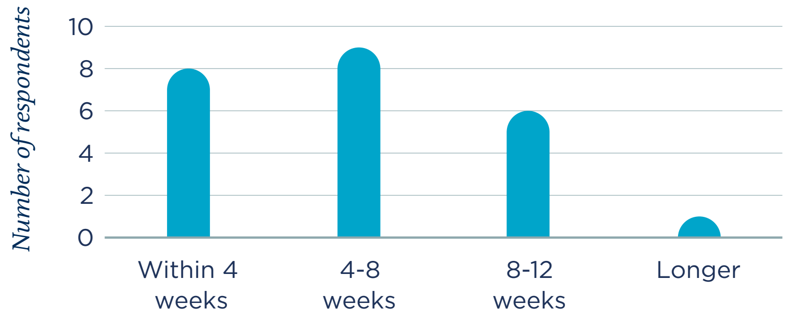
So it seems encouraging that in the longer term trustees can, to some extent, rely on their providers as an aggregator and checker of this information.

Do you have any internal procedures to check for reasonableness of the transaction costs that managers will be providing?

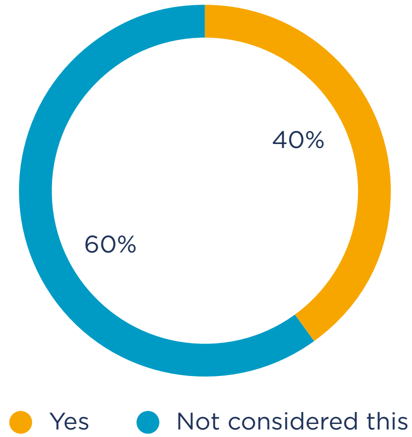


Encouragingly, both managers and providers believe that, given time, reporting these transaction costs will become standard practice. Around 70% of respondents are confident that in due course they will be able to provide data within eight weeks after each quarter end.

How soon after quarter end will you be in a position to provide transaction costs for your funds?



40% of providers would also remove a manager from the platform if they were unable to provide transaction costs in a reasonable period of time, giving further assurance that governance in this area is already being taken very seriously by a significant number of DC providers.



Conclusion

The FCA legislation mandating the calculation of transaction costs has been introduced at short notice. Managers and providers still need more time to build the internal technology that will record transaction costs, so it is looking increasingly unlikely that there will be complete disclosure of transaction costs in the coming months.

However, with the DWP requiring trustees to provide more detail on transaction costs, getting timely and accurate reporting on these is becoming more and more critical. We recommend trustees engage with their managers and providers about the importance of providing this information.

Taking a longer term view, the responses to our survey are very positive. Managers and providers are confident that in time the information will be readily available, and in a format that can be understood by all involved in running and saving into DC pensions. However we do have some concerns over more illiquid asset classes.

Independent transaction cost verification by providers should be seen as a huge bonus for schemes and will provide some comfort that the quality of data received from managers is reasonable. These costs will then finally be able to be measured, and trustees will be able to see if managers are proactively ensuring that transaction costs are being managed to ensure that funds deliver value for members.

Checklist for trustees

1. Understand your managers' and provider's stance on transaction costs:
   - When will they report this data after each quarter end?
   - Do they have checks in place to validate the data?
2. Understand how close your managers are to providing transaction costs using the slippage cost methodology
3. Contact your provider in advance of your report and account year end and let them know your requirements for the chair's statement and timeframes
4. Once transaction cost data is received, ensure it's assessed against costs for other managers who run assets in a similar style to see if your manager is delivering value for your members

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