To: Rt Hon Frank Field MP, Chair DWP Select Committee

Cost Transparency Inquiry

9/1/19

Dear Frank

A belated Happy New Year to you. I am sorry for the delay in replying to your letter, this was due to my leave over the holiday period. It was a great pleasure for me to give evidence to the Committee.

I have set out my answers to the questions you asked me to address in your letter.

“You said that trustees are still buying assets without knowing what the costs are. What are the specific areas which are not currently subject to a regulatory requirement for full transparency of charges and transaction costs?”

There is only a statutory requirement on DC schemes to disclose their costs and charges in two categories;

- Administration
- Transaction Costs

Administration costs are intended to cover all costs associated with running an investment vehicle other than the transaction costs. This will cover management fees, performance fees, platform fees, incidental costs.

The weakness in this approach is that it does not require the underlying costs to be split out, therefore disabling the opportunity to compare individual cost categories. It would be very useful for trustees to be able to establish the make-up of their costs and how they relate to similar products.

Transaction costs now have a defined reporting methodology, Slippage. This measure captures the difference between Arrival price and Execution price and will theoretically capture all the costs associated with a trade in any instrument.

This is a well-respected methodology by academics and will deliver an accurate transaction cost. Similarly, the weakness of this methodology is the inability to break out underlying cost categories, which is widely criticised as there are elements of transaction costs which can often offset each other.

For example, a brokerage commission could hypothetically be offset by a market movement in the opposite direction, which distorts the end figure. In reality, this is a minor shortcoming as evidence shows that it is rare for a negative market movement to impact over a longer investment horizon.

That said, the slippage methodology is sound however we think it can be made more useful if there is an attempt to collect contextual information with the cost, such as turnover split between cash in/outflows and discretionary manager decisions. Furthermore the slippage methodology does not cover all investment assets such as property, and private equity funds, such as are currently being promoted as ‘patient’ capital.

In the end we believe the IDWG templates should be used now that they have been made available by the FCA’s Institutional Disclosure Working Group. This could be rectified by statutory guidance to be issued by the DWP.

“You suggested that increased transparency of costs could help show whether DB schemes are providing value for money. Is there any information already available to indicate to what extent costs are affecting the performance of DB schemes?”

Cost transparency and improved returns for DB

Gaining cost transparency can improve the financial returns to the LGPS funds in a number of ways.

- Renegotiation of fees that have been charged above the asset management fee
- Reductions in costs paid once the full transparency has been met
- Changes in investment manager or investment strategy once full transparency has been met

## Case studies

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<th>Railpen</th>
<th>Activity/Outcome</th>
<th>Results</th>
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| "The asset owner must fully understand both total costs and what returns these costs are expected to deliver. This is achieved by considering two dimensions sometimes overlooked: measuring all costs, including hidden fees, and assessing ex ante the value-add from the investment mandate, whether internal or external" | "Our own analysis has estimated the total costs paid by Railpen on the aggregate portfolios in the past were higher than the headline figures, largely due to hidden charges in private markets. It is also important to model the expected returns – and range thereof – from a given investment to enable a judgement to be made on whether the expected value-add after costs produces a fair division between the asset owner and asset manager" | External benchmarking was comforting, but.  
Asset management costs stated were £70m.  
Post analysis they rose to £290m. (400% increase)  
Target to reduce costs by £100m in five years.  
Hit £50m reduction in two years.  
Continue to improve cost discovery, measurement and monitoring |

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<th>West Midlands LGPS</th>
<th>Activity/Outcome</th>
<th>Results</th>
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| The Scheme Advisory Board recommended in 2015 that all schemes collect all invoices per the new CIPFA recommendations. Of the 89 funds in England and Wales only 10 complied. Of these, only one made a concerted effort, West Midlands. | £10mn stated investment management costs grew to £90mn after analysis of missing invoices in public markets | In this case study the costs that were collected were not new or complicated in any way. They were just invoices from asset managers that should have been submitted but weren’t.  
Collecting these unsubmitted invoices from one year to the next resulted in an approximate 900% increase in reported costs. This immediately gave room for negotiation and the following year, invoices were reduced by £30mn or 28-99bps on a like-for-like basis. Scale that up across the whole of the LGPS (£250bn) and it represents a saving of more than £200mn per year. This particular case study confirms that going for the low-hanging fruit is worthwhile and can achieve early savings in costs. |

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<th>Netherlands</th>
<th>Activity/Outcome</th>
<th>Results</th>
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<td>In general, there is a greater emphasis on cost management across the Dutch pension industry, largely as a result of the significant improvement in cost reporting over the past five years. This has been the result of the combined</td>
<td>Six years on from the initial work by the AFM in 2011, cost disclosure is now well established. Of the 250 pension funds in the country, 100% now report pension administration costs, and reporting of both asset management</td>
<td>The impact of the regime has been significant. There has been a dramatic reduction in the number of pension fund holders with reported total costs (including administration costs) above 1.5% per annum of the total assets: In 2011 there were</td>
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efforts of multiple interested parties, such as the pension funds themselves, their asset managers, the Pensiöenfederatie, the Council for annual reporting and the DNB.

and transaction costs are both well above 90 per cent. Given that there was effectively zero transparency as recently as 2010 (beyond normal recording of invoices submitted by fund managers in the annual accounts) this represents impressively rapid progress.

approximately 790,000 participants (on the basis of the above DIM publication from that year) and approximately 66,000 participants by 2013.

"You recommended introducing a compulsory cost disclosure scheme, similar to that in the Netherlands. Could you explain how this was achieved in the Netherlands and what level of detail was required in the regulations? Would this be sufficient to provide full transparency of total costs in the UK?

Netherlands: fee transparency and reporting to regulators
Dutch pension funds comprise some of the largest funds in the world. There is an important amount of media and public attention around the investments and operations of pension funds generally. Dutch regulation requires pension funds to disclose standardised data points that are drawn from the template developed by the Federation of Dutch Pension Funds.

Legislative or regulatory requirements around fee disclosure
In spring 2011, the Dutch Financial Conduct Authority (AFM) published a report in which it concluded that the administrative costs of pension funds were much higher than reported in the annual accounts. The report exposed a variety of hidden costs, suggesting that the total costs paid by pension funds for asset management services were higher than assumed.

These conclusions came as a surprise to many. Members of parliament demanded quick action and called for new legislation for cost transparency. Nonetheless, Dutch pension funds were aware that their reported costs did not cover all costs. The annual accounts are written following Dutch Generally Accepted Accounting Principles (GAAP). Those rules prescribed that transaction costs and management fees should be deducted from returns. As a result, the profit and loss/income statements disclose net returns, instead of gross return and costs of asset management.

In 2015 the Pension Act was changed and cost disclosure in the annual report became mandatory. Dutch law refers to the “Recommendations” that were developed by the Federation of Dutch funds in 2011 to prescribe which costs should be reported and how they should be calculated.

Under the Pension Act, pension funds are obliged to report the following key numbers:
• Costs related to pension management in euros per member. The number of members is the sum of active members and pensioners;
• Asset management costs as a percentage of the average asset under management;
• Transaction costs as a percentage of the average assets under management.

Voluntary initiatives around fee disclosure
In 2011, the Federation of the Dutch Pension Funds decided to write recommendations on cost transparency. The objective was to ensure that the Dutch government could draw from standards developed by the pension sector if it chose to enact legislation around mandatory fee disclosure. The threat of legislation that did not account for differences between pension funds convinced most pension fund managers that self-regulation would be beneficial.

The outcome was the design of a cost collection template upon which Dutch asset managers agreed. The asset managers fill out the template and send it to their pension fund clients. These costs are then reviewed by the pension funds before being used to calculate the overall asset management fees and transaction
costs.

In spring 2016, the Federation launched an updated version of the recommendations. The most distinctive change from the 2011 model is the fact that the look through principle is applicable to transaction costs in fund of fund structures.

Impact of regulation, legislation or voluntary initiatives
The Netherlands has succeeded in implementing cost transparency in only a few years. Costs are on the agenda of the board of trustees and included in local legislation (Dutch GAAP and Dutch law).

The transparency outcomes for pension funds in the Netherlands are evolving. An overall decline of the percentage of pension investments in private equity and hedge funds has been witnessed. The Federation of Dutch Pension Funds feels the reason is found in several developments including cost transparency, the continued merger of pension funds along with an increase in internal management.

The following table shows a decline in the aggregated asset management costs and transactions over five years since the introduction of the collection and reporting system.

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<tr>
<th>Year</th>
<th>(A) Management fee</th>
<th>(B) Transaction costs</th>
<th>Cost of asset management (A+B)</th>
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<tr>
<td>2012</td>
<td>0.53%</td>
<td>0.13%</td>
<td>0.66%</td>
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<tr>
<td>2013</td>
<td>0.54%</td>
<td>0.10%</td>
<td>0.64%</td>
</tr>
<tr>
<td>2014</td>
<td>0.52%</td>
<td>0.09%</td>
<td>0.61%</td>
</tr>
<tr>
<td>2015</td>
<td>0.47%</td>
<td>0.08%</td>
<td>0.55%</td>
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<tr>
<td>2016</td>
<td>0.46%</td>
<td>0.08%</td>
<td>0.54%</td>
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Source: Data collected by the Federation of the Dutch Pension fund

“If there were to be a new regulatory requirement for trustees to collect and publish costs, would there be a need to provide them with additional support to enable them to fulfil this duty?”

Yes, I believe that this guidance could be offered by the TPR – either independently or in conjunction with the Institutional Disclosure Working Group mark II, now known as the Cost Transparency Imitative (CTI) held under the umbrella of the PLSA. Although I have concerns that the PLSA are a conflicted organisation in that they have banking and fund management affiliates.

The CTI will:
- Provide a clear voice for the interests of asset owners as we improve cost transparency.
- Run a pilot phase to test the new cost transparency templates and supporting technical and communications materials until January 2019.
- Following the pilot, roll-out the templates to the asset management and pensions industries to encourage fully transparent and standardised cost and charge information for institutional investors.

I think the old adage of what is measured is what matters applies here. In other words once trustees are required to collect, analyse and report on their costs it will become routine and they will pay far more attention to it. The real question for me is the government concerned with the efficiency of the pension system in the way the Dutch are.

Reductions in costs ultimately improve the investment performance for pension funds. These improvements should see improve the funding position of DB schemes and increase the size of DC pots. Subject of course to movements in asset markets and the overall performance of the macro-economy.

Thank you once again for requesting my evidence and I am very happy to assist with any other issues you may have.

Regards

Colin