FCA Asset Management Market Study

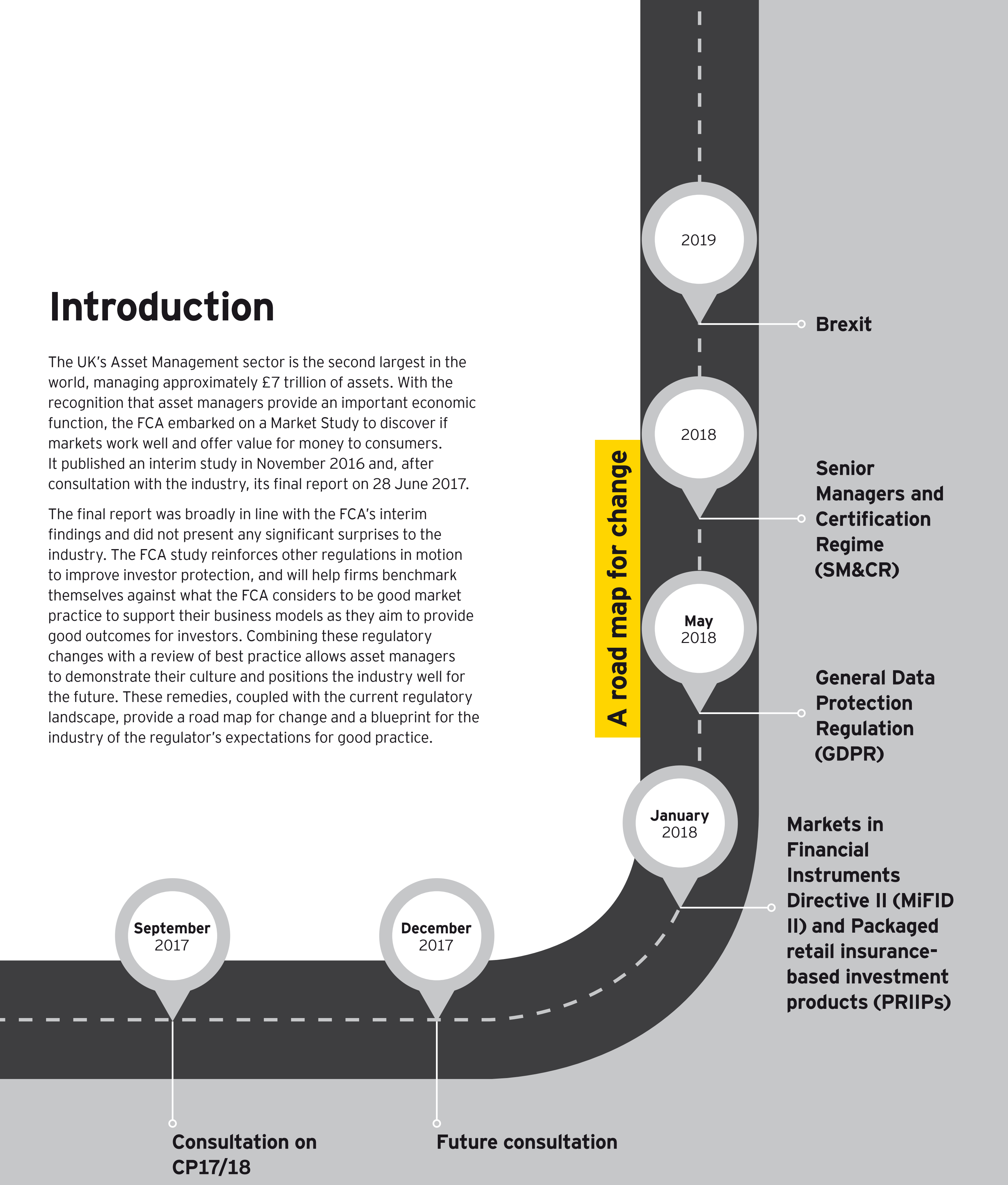
A blueprint for the industry

Building a better working world

Introduction

The UK's Asset Management sector is the second largest in the world, managing approximately £7 trillion of assets. With the recognition that asset managers provide an important economic function, the FCA embarked on a Market Study to discover if markets work well and offer value for money to consumers. It published an interim study in November 2016 and, after consultation with the industry, its final report on 28 June 2017.

The final report was broadly in line with the FCA's interim findings and did not present any significant surprises to the industry. The FCA study reinforces other regulations in motion to improve investor protection, and will help firms benchmark themselves against what the FCA considers to be good market practice to support their business models as they aim to provide good outcomes for investors. Combining these regulatory changes with a review of best practice allows asset managers to demonstrate their culture and positions the industry well for the future. These remedies, coupled with the current regulatory landscape, provide a road map for change and a blueprint for the industry of the regulator's expectations for good practice.



The FCA's consultation

1 No further consultation

- Recommendation to the Treasury to consider bringing investment consultants into its regulatory perimeter
- Recommendation to the Department for Work and Pensions (DWP) to remove barriers to pension scheme consolidation and pooling
- Recommendation to industry and investor representatives to agree standardised disclosure of costs and charges to institutional investors
- Market Study into Investment Platforms, which was released by the FCA on 17 July 2017

2 Consultation on CP17/18*

- Strengthening the duty of fund managers to act in the best interests of investors
- Requiring fund managers to return any risk-free box profits to the fund
- Facilitating switching investors to cheaper share classes
- Proposing to reject undertakings in lieu of a market investigation by the Competition and Markets Authority (CMA) in relation to the investment consultancy industry

3 Future consultation

- Costs and charges disclosure to retail investors to be consulted on in 2017
- Benchmarks and performance reporting to be consulted on in 2017
- Convening a working group on the objectives of the study and consulting on any rule changes at a later stage, subject to the outcome of the working group

*Responses due on 28 September 2017.

Key findings, themes and remedies

Fees and charges

The FCA has proposed to have a single all-in fee detailing all the costs that the investor will incur, including transaction costs. This single fee will allow for greater transparency for investors and provides a reference point for them when making decisions. The FCA recognises that this aligns with the requirements of MiFID II and PRIIPs, but did not provide a prescriptive approach or template for these charging structures. The FCA has indicated that it will consult further on this topic.

The FCA is keen that the industry provides greater transparency on performance fees and, in particular, firms should only be permitted to charge fees where the fund has performed above the most ambitious target after ongoing fees have been taken into account.

There is recognition that dual pricing for funds can benefit investors and is expected to continue; however, risk-free box profits should accrue to the fund and not be for the benefit of the manager.

Value for money for investors

The fund manager needs to ensure that they are engaged with investors and clear about what investors can expect from the fund. This would include, amongst other things, having it as a management objective and making it easier for fund managers to switch investors to cheaper share classes.

The FCA found that, on average, both actively and passively managed funds did not outperform their own benchmarks after fees. It wants to allow investors to be in a position to identify how their fund performs against the stated objectives; therefore, managers will need to ensure that the benchmarks are clear, showing past performance against the most ambitious target and that persistent underperformance is addressed.

The FCA will look at various areas to help with the measurement of value for money for investors. In particular, it will consult on the use of benchmarks, comparators or numerical target returns, which will involve considering why benchmarks have been used or not. It will also look at consistency across marketing materials, as well as an exploration of the use of language, to make it more useful for investors and their understanding of past performance presentations.

Regulatory structure and impact on business models

The FCA wants firms to strengthen the duty of asset managers to act in the best interests of investors and is seeking to provide greater protection for them. To this end, the FCA is aiming to increase accountability through the expansion of the SM&CR by extending it to authorised fund manager (AFM) boards and, in particular, requiring a consideration of value for money. The proposal to act in the best interest of investors would require an assessment on an ongoing basis and will need to be documented at least annually to include details on the economies of scale, fees and charges, share classes, quality of services and transparency.

The FCA is also proposing to strengthen the AFM boards by having a minimum of two independent directors on a board, making up at least 25% of total board membership. These independent directors need to have sufficient experience and expertise to fulfil their roles effectively.

Investment consultants

The FCA recommends bringing institutional advice under its regulatory scope, as this is an important means by which consultants impact the outcomes of institutional funds. The nature of such a regulation would consider the outcome of any CMA review of competition in the consulting industry.

The FCA considers that testing and reviewing the effectiveness of the advice provided by investment consultants more frequently will improve competition for investment consultancy services. This will benefit end clients from the perspective of lower costs and improved returns. This is key, given the large reliance that many schemes place on their investment consultants. Similarly, the FCA recognises that further transparency on fiduciary management fees and performance is needed to help assess value for money.

Value for money for investors

- The FCA is consulting on proposals to help investors switch to better value share classes by share class switching.
- It recommends that both industry and investor representatives agree a standardised template for costs and charges.

Fees and charges

- The FCA proposes to introduce a single all-in fee.
- It proposes to include costs that would be required under MiFID II and PRIIPs – including transaction costs.
- It is considering consulting on rules so that performance fees should only be permitted above the fund's most ambitious target after ongoing fees.

Key themes

- Investor protection
- Asset manager competition
- Intermediary effectiveness

Regulatory structure and impact on business models

- The FCA is aiming to improve governance by having a minimum of two independent directors on AFM boards.
- It is introducing value for money for investors as a distinct requirement for AFM boards under the proposed SM&CR extension.

Investment consultants and platforms

- The FCA is recommending that the offering of institutional advice comes under regulatory scope, considering the outcome of the CMA review of competition.
- It is testing and reviewing the effectiveness of advice provided by investment consultants more frequently with the intention of improving competition for investment consultancy services to benefit end investors.
- It is launching a Market Study into Investment Platforms due to the concerns about value of retail intermediaries.

EY view

The report has given a strong indication of what the FCA considers to be good market practice and provided a view of the direction of travel that it is expecting the industry to take. A number of the remedies proposed will almost certainly have an impact in driving a greater level of standardisation within the industry, and EY encourages firms to adopt these good practices. In terms of ensuring better investor outcomes, the report focused on:

- Better investor education and communication
- Aligning investor requirements with value for money
- Transparency and availability of cost information
- Governance and oversight

Barometer of good market practice

Firms are at different stages of maturity, with different business models and product or fund offerings. With the key areas of focus outlined by the FCA, firms have an opportunity to benchmark themselves against good practice. A firm that still takes risk-free box profits, is not clear on benchmarks, has consistently poor-performing funds, is finding the implementation of MiFID II and PRIIPs to be particularly challenging and is at risk of not meeting forthcoming standards will be cumulatively falling short of FCA expectations. Using our barometer, EY can help firms to identify their stage of maturity and guide them to establishing or cementing good practice.

Areas of focus	Basic
Better investor education and communication	▶ One-size-fits-all approach with limited investor feedback taken into account and a limited view of investor circumstances
Aligning investor requirements with value for money	▶ Limited ongoing monitoring of the product from a value perspective ▶ A suite of products may provide value, but limited ability to demonstrate alignment
Transparency and availability of cost information	▶ Providing the requisite information with limited assurance of investor understanding
Governance and oversight	▶ Limited demonstration of investor impact analysis taking place ▶ Limited demonstration of challenge

Established	Advanced	Actions for firms
▶ Approach takes account of differing investment strategies ▶ Providing ad hoc communications, such as portfolio manager market commentary	▶ Tailored communications approach aligned to investor segments and customer types based on factors, such as demographics and vulnerability ▶ Use of multiple communication channels	▶ Supporting investor education programmes by providing clear objectives and accuracy of product information ▶ Providing investor communication, including tools to help investors identify and understand fund performance
▶ Clarity at a firm level on what constitutes 'value for money' ▶ Monitoring is aligned to value for money	▶ Proactively review the language used and clarity of objectives, making them more useful for investors ▶ Provide granular and transparent performance reporting ▶ Have a value for money culture within the firm	▶ Review of product offering to ensure that it performs in line with investor expectations and objectives ▶ Review legacy share classes for 'fund switching' where appropriate
▶ Proactively guide and encourage the investor to examine the communication of cost information ▶ Have an understanding of the use of this information by the investor	▶ Ensure investor understanding throughout the product life cycle and be able to evidence this ▶ Transparency regarding alternative share classes and legacy products ▶ Understanding and alignment with different distribution channels, and the investor impact	▶ Consider impact on business models with upcoming regulatory changes ▶ Review the calculation engines and operational structure in support of greater transparency and the all-in fee
▶ Oversight through the product life cycle, with evidence of challenge ▶ Strong 'tone from the top' ▶ Limited or inconsistent investor impact analysis at product level	▶ Oversight, with appropriate representation from the business and challenge, throughout the product life cycle ▶ Demonstrating a strong investor-centric culture, with all levels of staff articulating these values	▶ Consider the upcoming SM&CR in the context of the firms' existing oversight and control framework ▶ Assess the options available for AFM boards to ensure ongoing compliance for all investors

Better investor education and communication

Investor education

Whilst recognising that there is a move by the FCA to improve transparency and increase value for money for investors, it is also important for investors to have an understanding and education of the wider investment world. For the FCA, investor education is part of the wider concept of 'financial capability'. In reaching its conclusions, the FCA acknowledged the benefits of improving financial literacy, but singled out three key areas for focus. These include concerns around the clarity of objectives, the clarity and accuracy of what investors are being sold, as well as any reporting. Improvements in these areas will allow investors to compare products better and thereby aid in improving investor outcomes.

In reaching the conclusions and proposed remedies, the FCA conducted extensive investor research which found significant differences in the way direct retail investors make their investment decision, with the level of overall investor education and awareness impacting the weight they place on the various factors influencing investing. A significant number of investors were found to be unaware of the difference between active and passive management, were not able to understand the relevance of benchmarks, could not distinguish between different types of fee structures to select the best value proposition for them, and were unaware of their ability to switch. Although there may be information that firms are providing to investors in various forms, it may be too complicated and, coupled with the use of industry vernacular, it can be hard for the investor to interpret. On this last point, the FCA has confirmed that it will examine whether it can improve the language used and clarity of objectives in order to make them more useful for investors at the point of sale as well as on an ongoing basis.

The ability of firms to meet any new regulatory requirements in this space will need to take account of the knowledge level of the investor. For example, the ongoing charges figure (OCF) is already produced within the Key Investor Information Document (KIID) and, therefore, extending the use of this metric into other client communications may not be difficult for firms, but ensuring and evidencing client understanding is a greater challenge that will need to be tackled. As investors move away from traditional face-to-face advice towards conducting their investment business in a digital setting — for example, by making use of platforms — fund providers and asset managers will need to ensure that they can support investors in making their investment decisions.

The level of transparency and disclosure is likely to aid investors in making appropriate choices. Improvements in disclosures of benchmarks, investment objectives, and fees and charges aids in reducing the moral hazard by drawing a line between the firm's responsibility for the provision of information and the investors' responsibility to make decisions based on that information. Simply meeting any new requirements in this area may not be enough. Behavioural economics may play a role in steering investors towards headline rates or discounting risk factors, for example, and as such firms must be alive to this reality.

Investor communication

The FCA's recommendations around greater disclosure and description of fund investments for retail investors are welcomed. This would include a greater clarity of fund objectives and greater transparency of past performance, coupled with a wider range of investment information to drive better investor choices. The focus on consistently underperforming funds and providing tools for investors to identify those funds, while welcomed, may be a challenge. For example, as acknowledged by the regulator, the evidence supporting the conclusion that funds which consistently underperform will continue to do so into the future is not clear, given the impact of fund mergers and closures. Further, the report also points out the common use of discretionary bonuses within the sector, and a lack of clawbacks or penalties for consistent underperformance. Whilst the FCA is not proposing any remedies to do with pay and performance, it is focused on ensuring that there is a good culture within the organisation.

Aligning investor requirements with value for money

The FCA has opined on value for money relating to three key areas and, although it has not been prescriptive on defining value for money, we encourage the industry to participate in obtaining clarity in order to avoid unintended consequences.

Product offering

The FCA is keen that asset managers demonstrate proper product governance and suitability assessments for their investors, and has noted that 'closet trackers' represent poor value for money. The FCA has confirmed that it will consult further on profitability in December 2017, but this is not expected to address specifically the area of 'index hugging'.

We encourage firms to review products regularly to ensure that they continue to perform in line with expectations and the fund objective, essentially ensuring investors are achieving value for money and the right outcomes. With the demand for innovation rising, as firms launch new products, they should take account of investor feedback in the product development stage and ensure that activities are evidenced sufficiently. Firms should also consider the benchmark being used in any fund documentation and assess whether it is appropriate for the fund.

Fund switching

The FCA found that a lack of switching indicated that investors do not proactively switch away from funds offering poor value for money. For the FCA, there is a distinction here between advised and non-advised, with the FCA indicating more concern for the latter group of investors who appear to face barriers to switching. The FCA is therefore proposing to consult on removing barriers for firms to move investors to cheaper share classes without expressed consent, where that is in the best interests of the investor. Firms may face legacy challenges in this regard, such as lack of investor contact data and dormant accounts, and potentially other inconsistencies in investor treatment which would need to be addressed in an appropriate manner. We would encourage firms to review these legacy products actively. Further, the FCA is consulting as to whether legacy trail on pre-Retail Distribution Review (RDR) investments should have a sunset clause. This could have a significant impact on advisers and wealth managers who are still receiving this commission. Firms should consider the commercial impact any sunset clause on trail commission will have on their business model.

Box profits

While the OCF figures provide the granularity of detail as to the revenue taken by asset managers, the FCA has expressed concern that risk-free box profits are opaque and are not passed through to investors. Therefore, the FCA is proposing that firms must pass risk-free box profits back to the fund. Firms that undertake this practice will need to review their existing procedures to ensure that they are able to change this approach. We believe that there will be an element of self-correction arising in the marketplace as a result.

Transparency and availability of cost information

Upcoming regulations

The findings and proposed remedies that the FCA has identified align very closely to the upcoming regulatory changes. Asset managers will need to carefully consider the impact of these changes on their business models at the same time as having to maintain compliance with numerous other ongoing regulatory initiatives, such as PRIIPs, SM&CR, Undertakings for the Collective Investment in Transferable Securities (UCITS V) and MiFID II.

Under MiFID II, there are enhanced disclosure requirements for costs and charges and, in particular, the need for costs and charges disclosures to include items, such as transaction costs and research fees, which will need to be unbundled from commission charges. All of this implies a level of consistency between the EU MiFID requirements and the FCA proposals. We recognise that firms have regulatory change programmes underway but that challenges still remain with the implementation and, in particular, the calculation of the all-in fee. Whilst the FCA Market Study was not prescriptive, it is encouraging to see that it is aligning its proposals with the upcoming regulation. We would suggest a level of standardisation, as well as encourage the Asset Management industry to look to other sectors for examples of good practice of identifying value-added service components, provided that any new approaches do not contravene the rules under current regulations (e.g., RDR) and proposed upcoming regulations (e.g., MiFID II and PRIIPs).

Performance and costs

The FCA has seen little improvement in the availability of transaction cost information to investors; in particular, the OCF does not currently include implicit or explicit transaction costs. While firms may be able to derive the various inputs to the costs and charges figure, as they cannot be crystallised until the future, firms will need to consider carefully how these estimates are best presented to investors. While there is currently no obligation for fund managers to display charges in monetary amounts, this will change under the upcoming MiFID II and PRIIPs requirements. Consideration of the inclusion of this figure in other pre-sales documents appears prudent in ensuring that the investor has a more holistic charging picture.

With the upcoming benchmark and performance reporting review expected later this year, we again would recommend that the industry participates in helping to define how best to create standardisation for benchmarks, with a view to providing greater clarity to investors. For segregated mandates, disclosure requirements are less regulated, but with the move towards greater transparency, firms should consider how best to achieve this. For example, through carrying out internal fund and product reviews on a regular basis across new, existing and legacy funds.

Governance and oversight

SM&CR

The impact of the introduction of the SM&CR is arguably only just beginning to become apparent for firms within the Financial Services sector, where the rules apply. The intention of the SM&CR is to improve governance by increasing accountability of senior material risk decision-makers within the firm. Whilst this requirement does not currently apply to the Asset Management sector, we would encourage firms to consider the SM&CR in the context of their existing oversight and control framework, given its forthcoming extension. The message from the study is to ensure that investors are at the centre of the decision-making process and that managers will need to ensure that they have taken reasonable steps to act in the best interests of investors. Whilst the metrics and measures for defining value for money was not set out in the study, we would encourage firms to consider their product development life cycle, their sales approach and client documentation. Having an appropriate tone from the top will assist with improving the firm's culture and assist the industry with rebuilding trust.

AFM boards

The FCA has recognised that changes regarding investor information needs to be coupled with improved governance. Regardless of asset classes that firms specialise in, be it active, passive or alternative investment strategies, the proposed changes to AFM models mean that firms will need to consider if the existing structure and arrangements are fit for purpose, and assess the options available to ensure ongoing compliance for all investors. This will be a particular challenge with respect to the proposed requirement for at least two independent directors with sufficient knowledge and experience, as there will be greater demand for individuals with the required skill sets. While no doubt improving fund governance and oversight, these requirements may present their own set of challenges in areas such as recruitment and ongoing monitoring. Firms that operate investment trusts, unit-linked funds and with-profits businesses, including insurance companies, will need to consider the FCA's proposal to extend the independence and value for money requirements of AFMs to the governance of these other types of investment vehicles.

Implementing good market practice – a product life cycle case study

A continual cycle of review and feedback, with the customer at the centre of the product development process, will not only be an important step for firms to address the points arising in the Market Study, but will also support them in the implementation of MiFID II.

The diagram below articulates the steps that firms can take along the stages of the product development life cycle.

Spotlight on fees and charges — impact for Alternative Funds

Whilst recognising that there is currently no standard industry approach for detailing all the relevant costs and charges, the FCA intends to do some further work to align MiFID II, PRIIPs and its own guidance on cost disclosures. Having an independent body made up of industry representatives to support a 'disclosure code' that would apply to all participants in the industry, including alternative asset managers, would go a long way to supporting the industry.

Although certain Alternative Funds would not be directly impacted by MiFID II or PRIIPs, the FCA may require alternative asset managers to meet the new transparency guidelines. This could potentially include details on estimated aggregated costs and charges figures on a pre-trade basis, whilst requiring actual costs and charges disclosures at the end of the year. This effort on alignment within the industry is welcome, and EY would encourage alternative asset managers to work with the FCA on this consultation. In the meantime, we would encourage both alternative and traditional asset managers to work on their calculation engines and operational infrastructure, as well as participate in wider industry discussions with a view to support the establishment of a standard template. This effort will help firms with the demand for greater transparency for investors and support them in providing an all-in fee.

Spotlight on Platforms

On 17 July 2017, the FCA announced the launch of a Market Study into Investment Platforms to examine how competition is working within this market. It has indicated that it will look at whether Platforms provide clear communication of costs, ensure that the benefits of economies of scale are passed onto the investor and will evaluate the vertical integration of advice and fund management. In effect, it seems the FCA is assessing whether platforms are merely administrative tools to facilitate decisions made by individual investors (or their advisors) or whether platforms can determine what products investors buy and at what cost. If the latter case is correct, the FCA might revisit topics such as conduct of business standards regarding conflicts of interest and duties to secure value. Consideration may also be given to allowing or requiring Platforms to identify poor-performing funds. This would align to the themes that have been consistent throughout the report about making the end investors' interests central to the businesses of all participants in the asset management industry.

Spotlight on investment consultants

The FCA's review suggests that lower concentration of the investment consultancy market and higher switching rates will drive fees lower and test the quality of advice, particularly around manager selection; the overall impact should be better risk-adjusted returns (net of fees) for investors. In principle, a potential review by the CMA should drive consultants to show clearly the value they add. With an increase in the complexity of investment, we also encourage consultants to illustrate the value of their advice relative to a much simpler investment strategy that an investor could take. It is important to consider that decision-making for pension schemes is made by trustees rather than investment professionals. As such, decision-making on the choice of investment consultant and asset managers is often driven by relationships and quality of presentations rather than investment issues specifically. Unless there is a meaningful change in the ability of trustees to make decisions more rationally, the effectiveness of forced reviews of investment consultants may not achieve much.

Conflicts of interest relating to the provision of fiduciary management businesses is also on the FCA's radar. A fiduciary model covers a larger range of activities, which should result in higher fees. If this results in better outcomes (net of fees) for investors, then perhaps there is no conflict — it would just be a higher price for a better service. Clearly, if fiduciary management results in worse outcomes for an investor and higher fees paid to the fiduciary firm, then there is a conflict. The FCA review does not suggest that fiduciary management results in weaker outcomes; it is indeed considered as a means of pooling assets to achieve lower costs and implement a wider range of investment strategies.

Conflicts or not, the key for investors using fiduciary management is to be able to test the quality of a fiduciary management service and compare different providers objectively. With a wide range of fiduciary management models and services, and therefore fee structures, it can be difficult for many institutional investors to differentiate between providers — the heterogeneity of services offered means that, even if we do have a lot of publically available performance data, identifying relevant data may not be straightforward. The use of independent advisers to achieve the required transparency is already common, and may become even more common following the FCA review. Of course, the word 'independent' is key here — a firm that provides one of investment consulting, fiduciary management or asset management services is likely to be conflicted in some way — an issue that is already at the core of the FCA's concerns.

Conclusion

EY welcomes the FCA's Asset Management Market Study — the largest of its kind. This is not a 'do nothing' report; what we see is a package of remedies, including a reinforcement of other regulations in motion, to improve investor protection.

This report comes at a pivotal time for the Asset Management industry. There are pressures on two fronts:

1. Cost pressures in giving customers value for money
2. Regulatory pressures as asset managers continue to demonstrate a culture that goes beyond compliance to specific rules

This demonstrates that the end investor should be at the heart of what the asset manager does. This Market Study report should be welcomed by the industry, given the overall objective of increasing investor confidence and, ultimately, supporting the increase of long-term savings in the UK.

It is imperative that the culture and the tone from the top is considered by individual firms. Whilst many Asset Management firms will be on a path to addressing most of the findings contained within the report, based on existing programmes of work, there will be some firms in the industry for whom this report is a call to action to get their houses in order.

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