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Comisión Nacional del Mercado de Valores

Final report published by the Financial Conduct Authority on its asset management market study

On 28 June, the Financial Conduct Authority (FCA) published the results of its asset management market study and announced a set of remedies to improve competition and to address the concerns identified.

The UK's asset management industry is the second largest in the world, managing around £6.9 trillion of assets. Over £1 trillion is managed for retail investors and £3 trillion on behalf of pension funds and other institutional clients. The industry also manages around £2.7 trillion for overseas clients.
Over three quarters of UK households are saving for, or receiving, pensions that rely on management services, whether directly or indirectly. There are also around 11 million savers with investment products such as stocks and shares ISAs as an alternative to traditional cash savings accounts. The services offered to investors include searching for return, risk management and administration.

The starting point of this report is the interim report published in November 2016 on the same subject. In light of the conclusions of the interim report, the FCA consulted widely on its findings and conducted further analysis, which led to it proposing a series of remedies.

It was found that there is weak price competition in a number of areas of the industry. Even though there is a high number of companies operating in the market, there is evidence that the profits obtained by firms have been high and sustained over a number of years. The FCA also found that investors sometimes do not clearly understand the performance objectives of the recommended funds, and that the fund performance is not always expressed against the appropriate benchmark. There are also concerns about the functioning of the investment consultant market.

For the FCA, the main goal is that investors should be able to understand the total cost of the investment and the fund's objectives so that they are able to choose the most appropriate product for their needs, whether this is an actively managed fund or a passively managed fund.
The main findings are summarised below:

1. Price competition

The evidence suggests that firms do not lower prices to win new business, especially for retail active asset management services. Although in the case of institutional clients, prices tend to fall as the size of the mandate increases, this was not the case for equivalently sized retail funds.

The FCA found that there is considerable price clustering on the asset management charge for retail funds and active charges have remained broadly stable over the last 10 years. This, together with the fact that levels of profitability are high, with average profit margins of 36% for the firms sampled, indicates that price competition is not working as effectively as it could be.

2. Performance

Although the study found substantial variation in performance, both across asset classes and within them, the evidence suggests that, on average, both actively managed and passively managed funds did not outperform their own benchmarks after fees. This finding applies for both retail and institutional investors.

The FCA looked at whether investors, when choosing funds, may choose to invest in funds with higher charges in the expectation of achieving higher future returns. The analysis suggests that there is no clear relationship between charges and the gross performance of retail active funds and that there is, in fact, some evidence of a negative relationship between net returns and charges. This leads to the conclusion that investors who chose active funds with higher charges, on average, achieve worse performance.

Furthermore, the study found that it is difficult for investors to identify outperforming funds, partly because it is often difficult for investors to interpret past performance information. However, it is widely accepted that past performance is not a good guide to future performance.

In addition, there is evidence of persistent poor performance of funds. Worse performing funds were more likely to merge into better performing funds, which usually improves the performance of the merging poorer performing funds, but not that of the recipient funds, although it is not clear that this is as a direct result of the merger. While mergers and closures of persistently poor performing funds may improve outcomes for some investors, not all of them are merged or closed and, it can also take a long time for such funds to do so.

3. Clarity of objectives and charges

There are concerns about how asset managers communicate their objectives to clients, in particular how useful they are for retail investors. In addition, there are active funds that offer similar exposure to passive funds but which have significantly higher charges. It is estimated that there is around £109bn in "*active*" funds that closely mirror the market which are significantly more expensive than passive funds.

Value for money is normally considered to be some form of risk-adjusted net return. This can be broken down into performance achieved, the risk taken on to achieve it and the price paid for the investment management services. However, investors' awareness and focus on charges is mixed and often poor. A significant number of retail investors are not aware they are paying charges for the services they receive. However, many institutional investors and some retail investors are increasingly focused on charges.

4. Investment consulting and other intermediaries

Significant differences were found in both the behaviour and outcomes of different institutional investors. While a number of large institutional investors are able to negotiate very effectively and get good value for money, smaller institutional investors, typically pension funds, find it harder to negotiate with asset managers. These clients generally rely more on investment consultants when making decisions.

However, the report identifies some concerns in the investment consulting market. These include the relatively high and stable market shares for the three largest providers, a weak demand side, relatively low switching levels and conflicts of interest.

In addition, retail investors do not appear to benefit from economies of scale when pooling their money together through direct-to-consumer platforms and there are doubts about the value that retail intermediaries provide.

<u>The package of remedies has been classified according to objectives as follows</u>:

With the **aim of providing protection for investors who are not well placed to find better value for money**, the FCA proposes:

• Strengthening the duty on fund managers to act in the best interests of investors through clarifying the FCA's expectations, introducing a minimum level of independence (through independent directors in their boards) in governance structures and introducing a series of responsibilities for senior managers to ensure that every part of the firm's business has one senior manager with overall responsibility for it.

• Requiring fund managers to return any risk-free box profits to the fund and disclose box management practices to investors (these practices consist of having different subscription and redemption prices to cover the costs of investing and disinvesting underlying securities. If subscription and redemption orders are matched, that difference in prices results in risk-free box profits).

• Making it easier to switch investors to more beneficial share classes.

With the **aim of driving competitive pressure on asset managers**, the FCA proposes:

• Promoting the disclosure of a single all-in fee to investors (MiFID II will introduce this for investors using intermediaries), which will include the asset management charge and an estimate of transaction charges.

• Promoting consistent and standardised disclosure of costs and charges to institutional investors by using standardised templates, which will be developed.

• Recommending that the Department of Work and Pensions remove barriers to pension scheme consolidation so as to allow them to benefit from economies of scale.

• Chairing a working group to consider how to make funds' objectives clearer and more useful for investors. The FCA intends to consult on requiring managers to be clear about why a benchmark has been used or not and requiring that the use or otherwise of benchmarks is consistent across marketing materials. It also intends to consult to clarify that where managers present past performance they must do so against the most ambitious target held out to investors (for example, if the aim is to achieve a return of LIBOR + 4%, the information must be made with regard to this target and not only to the LIBOR).

With the **aim of improving the effectiveness of intermediaries**, the FCA proposes:

• Launching a market study into investment platforms to look at competition in that market.

• Deciding whether to make a market investigation reference to the Competition and Markets Authority to further investigate the investment consultancy services sector with the aim of resolving the aforementioned problems. In fact, the three largest investment consultants provided undertakings to provide information on costs and returns in standardised templates, together with changes to address conflicts of interest and strengthen their internal processes. However, this solution will be rejected as it is not considered to be sufficient.

• Recommending that the Treasury consider bringing investment consultants into the FCA's regulatory perimeter.

Some of these remedies may be implemented immediately while others require working groups and/or subsequent consultations. It is also important to bear in mind that some of the recent and future national and European regulatory changes which affect the sector already address, in some cases, these problems and therefore the package of remedies aims to support and supplement these changes.
The FCA is also considering applying measures to improve the transparency of information charges for alternative investment vehicles, such as private equity funds and hedge funds after having received comments that this is a particularly opaque part of the sector.

It is also considering extending the scope of the reforms to include unit-linked or with-profits insurance products sold by insurance companies to retail investors as the issues relating to governance and value for

money also apply in these products.

The FCA launched on 16 October its new asset management authorisation hub to support new firms by assisting when they apply for authorisation, throughout the authorisation process and afterwards. By this it will be offered to new firms pre-application meetings, dedicated case officers and access to the new website portal. This will make it easier for firms to understand how the FCA works, make a complete submission, and transition from our authorisation to supervision regime.

Links:

Report on the asset management sector published by the FCA

FCA launches the Asset Management Authorisation Hub