Financial Services Consumer Panel

AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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European Banking Authority
European Insurance & Occupational Pensions Authority
European Securities & Markets Authority☐

29 July 2015

Dear Sir, Madam,

Technical Discussion Paper on Risk, Performance Scenarios and Cost Disclosures in Key Information Documents under PRIIPs

This the response of the Financial Services Consumer Panel to the ESA's joint Technical Discussion Paper on Risk, Performance Scenarios and Cost Disclosures in Key Information Documents under PRIIPs. The Consumer Panel is grateful for this opportunity to set out its views on the content and format of the KID.

Under the terms of the 2000 Financial Services and Markets Act as amended by 2012 Financial Services Act, the UK's Financial Conduct Authority (FCA) is required to set up and maintain a panel to represent the consumer interest. The panel set up under the Act - the Financial Services Consumer Panel - operates independently of the FCA. The emphasis of its work is on activities that are regulated by the FCA, although it may also look at the impact on consumers of activities that are not regulated but are related to the FCA's general duties.

The Consumer Panel takes a close interest in the transparency and fairness of fees charged to retail investors, as fees have a significant impact on investment returns. We are broadly supportive of the direction the ESAs are taking on disclosure of costs, risks and returns through the Key Information Document in this discussion paper.

The Panel would like to reiterate some of the points we made in our response[1] to the initial discussion paper published earlier this year. We feel that the proposed scope of the KID, though ambitious, does not fully reflect the complexities of retail fund structures, the asymmetries of information between firms and investors, and the conflicts of interest in the asset management industry.

The relationship between costs, risks and rewards

The Panel has previously raised concerns about the narrow definition of the concept of 'risk' proposed by the ESAs in their earlier discussion paper. Although the direction of travel now appears set, we again strongly challenge the assumption underpinning the discussion paper that risks are purely stock market-related, such as the potential for loss of capital or liquidity issues.

Research[2] undertaken on behalf of the Consumer Panel has shown that asset manager conduct and practice, the weak principal-agent relationship, and the arbitrage between different fund structures are also relevant to the risks associated with an investment product, and whether these risks are understood by the investor.

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[1] https://fs-cp.org.uk/sites/default/files/cp_response_kids_under_prips_20150217.pdf
[2] https://fs-cp.org.uk/fca-publications?field_fcacp_publication_date_value%5Bmin%5D%5Bdate%5D=17%2F11%2F2014&field_fcacp_publication_date_value%5Bmax%5D%5Bdate%5D=17%2F11%2F2014

A 2010 report commissioned by the European Commission[3] found that consumers were often confused by the true nature of their investment products, and that nearly 40% of investors in stocks and shares (wrongly) believed their initial investment was protected.

In addition to the impact of consumers' poor understanding of investment risk, the Panel's own research also showed that the level of costs and charges applied against underlying assets has a large effect on return.[4] Therefore, when considering market risk, costs and charges applied must be taken into account. The link between asset management costs and returns is unlikely to be clear to most retail investors if it is not included in the narrative risk description to be included in the KID.

By limiting the definition to market, credit and liquidity risks, we are concerned that the resulting indicator will not accurately reflect the impact of hidden, indirect, costs. We hope that the ESAs will take these considerations into account when formulating their regulatory technical standards for the European Commission.

Yours sincerely,

Sue Lewis

Chair, Financial Services Consumer Panel

[3] http://ec.europa.eu/consumers/archive/strategy/docs/final_report_en.pdf

[4] There is a body of evidence that shows that apparently relatively small differences in costs can have a big impact on the value of savings over time. The UK Department for Work and Pensions in its report "Reinvigorating workplace pensions" highlighted that an annual management charge (AMC) of 1.5% p.a. reduced a final pension pot by 22% after 40 years because of the lost compound growth potential whereas an AMC of 0.5% reduced the pot by 9%.

Consultation Questions

Question 7: Do you agree that liquidity issues should be reflected in the risk section, in addition to clarifications provided in other section of the KID?

Yes. Consumers are likely to want to be aware of this type of risk before purchasing the product.

Question 15: Please express your views on the assessment described above and the relative relevance of the different criteria that may be considered.

Type of performance scenario

The Panel believes that any performance scenarios should be based on the most likely or realistic outcome for a given investment. It would therefore support use of the probabilistic method for calculating performance scenarios.

Crucially, any performance scenario included in the KID must show the negative as well as the positive effects, and the potential return should be shown *after* costs, charges and an assumption for inflation are taken into account.

Most importantly, a consistent approach should be taken by all providers of KIDs, particularly on assumptions for growth and inflation. However, providers could be made to make an assumption about the effect of their own costs and charges based on, for example, costs applied against the underlying assets over the past 3 years. It is vital this should include *all* costs, not just the headline annual management charge (AMC) or total expense ratio (TER).

Research[5] undertaken on behalf of the Consumer Panel has shown that reported figures such as AMC or TER represent only a fraction of the true costs investors pay. Notably, they do not include undisclosed transaction costs which evidence suggests could,, for example, add almost 1.5% per annum to the disclosed costs of a collective investment scheme.[6]

Moreover, if the probabilistic approach to performance scenarios is chosen, using historic data, then a longer time frame, at least 10 years, should be used. The Panel's recent research shows that performance data based on annual or 5-year periods does not provide meaningful information and can produce results that are misleading.

As regards use of historical data to calculate potential performance, the Panel would also note that from a behavioural perspective, most retail investors do not distinguish between 'risk' and mathematical probability (uncertainty).[7]

Prescribed approach to performance scenarios

The Panel is concerned that too lax an approach to determining the parameters of the performance scenarios that can be used in the KID would lead to consumers being targeted with materials featuring unrealistic probable returns on an investment.

The Panel would strongly urge the ESAs to avoid giving manufacturers the responsibility to select performance scenarios. High-level principles to guide scenario selection would be impossible to enforce in practice, and would likely lead to the promise of overly optimistic returns. Moreover, such discretion for individual manufacturers would reduce the comparability of offers, which is a key objective of the Key Information Document.

It is likely that the prescribed approach,will result in some regulatory arbitrage as manufacturers of UCITS will face less strict requirements in presenting their products to retail investors under the KII guidelines. This is an unfortunate by-product of the exemption of UCITS from the PRIIPs

[5] https://fs-cp.org.uk/fca-publications?field_fcacp_publication_date_value%5Bmin%5D%5Bdate%5D=17%2F11%2F2014&field_fcacp_publication_date_value%5Bmax%5D%5Bdate%5D=17%2F11%2F2014
[6] Edelen, Evans and Kadlec (2007): 'Scale effects in mutual fund performance: The role of trading costs'.
[7] OECD Working Papers on Finance, Insurance and Private Pensions No. 19, page 23.

Regulation, which is also at the root of potential problems in the disclosure of transaction costs by intermediaries under the new MiFID II Directive.[8]

The Panel hopes that the EU legislators will use the next available opportunity to bring UCITS in scope of the PRIIPs Regulation to make the EU legislative framework for investment products as consistent as possible across different sectors.

Relationship between charges and returns

The level of disclosed and undisclosed charges will have a direct effect on the return of the investment and should therefore be included.

After a review of a wide range of studies and methods for calculating costs, research the Panel commissioned in 2014 concluded that the full costs borne by investors are simply not known. Many costs are deducted from the fund directly; many are not properly measured or declared. Even fund managers frequently do not appear to know: in its survey of fees, consultancy Lane Clark & Peacock, found that around two-thirds of investment managers could not provide information on transaction costs.[9]

Moreover, explicit costs charged to the customer – included within the annual management charge (AMC), the total expense ratio (TER) and the ongoing charge figure (OCF) – are a poor guide to the full costs. This was the conclusion of a 2000 study commissioned by the UK's Financial Services Authority[10] and holds true in more recent studies.[11] ,[12]

Accordingly, in particular for products that are likely to include a large number of transactions (and where transactions costs are thus likely to be high) the potential for charges to lead to lower overall returns should be clearly communicated to the investor, using the narrative risk descriptor if necessary.

At the very least portfolio turnover rate should be incorporated into the risk indicator, as a high level of transactions is traditionally associated with higher risk, and is therefore relevant. Moreover, the KID should make clear in the risk narrative what the 'worst case' scenario is for the retail investor.

In most cases, this would be the complete loss of the capital investment, but it should be made clear to consumers where the actual losses could be higher than the initial investment (for example where charges exceed returns, or in the case of contracts for difference).

Testing performance scenarios

The Panel is pleased with the decision by the European Commission and the ESAs to consumer-test the content and presentation of the KID prior to the adoption of the final technical advice. However, it would urge the ESAs to also conduct ex-post testing of the Key Information Document once it has been in use. This should in particular look at:

- Whether consumers understand the information in the KID;
- Whether there is more or different types of information which consumers might find helpful if included in the KID;
- Whether the performance scenarios have turned out to give reasonably accurate indications about possible risks and returns.

[8] As the PRIIPs Regulation will not apply to manufacturers of UCITS funds until 31 December 2019 at the earliest, there will be parallel yet divergent disclosure practices for different types of retail investment products, with less stringent requirements applicable to UCITS despite the fact that these are the most popular type of retail investment.
[9] Lane Clark & Peacock (2013), "LCP Investment Management Fees Survey 2013"
[10] Financial Services Authority (2000), "Occasional Paper 6: The Price of Retail Investing in the UK"
[11] Edelen, Evans and Kadlec (2007): 'Scale effects in mutual fund performance: The role of trading costs'.
[12] DWP (2008) Costs of running pension schemes: findings of a feasibility study, John Leston, Margaret Watmough and Jennifer Ross of RS Consulting, Research Report No 535.

Question 16: Do you think that these principles are sufficient to avoid the risks of manufacturers presenting a non-realistic performance picture of the product? Do you think that they should be reinforced?

As noted above, the Panel believes that regulators should take a more active approach in prescribing which types of performance scenarios can be used. The use of principles as part of non-binding guidelines is unlikely to prevent the use of unrealistic performance scenarios in KIDs.

Question 34: Is this description [of transaction costs] comprehensive?

In order for the KID to provide consumers with a meaningful tool for comparison between different products, the information on costs must be as comprehensive as possible, and not allow for a 'waterbed' effect.

The Panel has welcomed the inclusion in the PRIIPs Regulation of a requirement for the KID to include disclosure of costs of all types, whether direct, indirect, one-off or recurring in nature. However, it will be difficult to achieve a truly representative figure of the costs associated with a particular product. In many instances, the total costs simply are not known because of opaque cost structures in the retail investment market, especially for transaction costs.[13] This prevents meaningful comparison between different investment products covered by the PRIIPs Regulation, undermining the usefulness of the KID. We would also observe that it would be useful to align cost calculation methodologies with the approach to be adopted under MiFID II as much as possible.

After a review of a wide range of studies and methods of calculation, research the Panel commissioned in 2014 concluded that the full costs borne by savers are simply not known. Many costs are deducted from the fund directly; many are not properly measured or declared. Even fund managers frequently do not appear to know: in its survey of fees, consultancy Lane Clark & Peacock, found that around two-thirds of investment managers could not provide information on transaction costs.[14]

Moreover, explicit costs charged to the customer – included within the annual management charge (AMC), the total expense ratio (TER) and the ongoing charge figure (OCF) – are a poor guide to the full costs. This was the conclusion of a 2000 study commissioned by the UK's Financial Services Authority[15] and holds true in more recent studies.[16] [17]

In one study, "total" charges, excluding transaction charges, were calculated (with difficulty) from published, but not necessarily comprehensive, mutual fund price lists. They were typically more than twice the annual management charge in a number of countries, including EU Member States such as the UK.

The problem is so entrenched that even institutional investors of multi-billion pound pension funds may not know the full costs of investing. It took a major study by Hymans Robertson, a pensions consultancy, to find potential for significant savings in the UK's Local Government Pension Scheme by switching to passive investments away from generally underperforming actively managed funds.[18] Similarly, Railpen Investments, a £20 billion pension scheme, was only able to estimate with great difficulty that the headline fees it paid to asset managers were around a fifth of total costs.[19]

In November 2014, the Panel published a discussion paper[20] which outlined a number of recommendations to address these issues. The Panel considers that disclosure of costs (and risks) is only effective if those to whom the details are provided can understand and act on the information; overly complex disclosure to consumers would be counterproductive in many cases.

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[13] https://fs-cp.org.uk/sites/default/files/investment_jaitly_final_report_full_report.pdf#page=22
[14] Lane Clark & Peacock (2013), "LCP Investment Management Fees Survey 2013"
[15] Financial Services Authority (2000), "Occasional Paper 6: The Price of Retail Investing in the UK"
[16] Edelen, Evans and Kadlec (2007): 'Scale effects in mutual fund performance: The role of trading costs'.
[17] DWP (2008) Costs of running pension schemes: findings of a feasibility study, John Leston, Margaret Watmough and Jennifer Ross of RS Consulting, Research Report No 535.
[18] Hymans Robertson LLP report for Vanguard (2011), "Fund structures for pension funds"
[19] http://www.ft.com/cms/s/0/74691e26-52eb-11e4-9221-00144feab7de.html#axzz3g4GaElos
[20] https://fs-cp.org.uk/sites/default/files/investment_discussion_paper_investment_cost_and_charges.pdf

In addition, disclosure by itself would not immediately change the incentives for fund managers to control those costs that can be charged against the fund and which are consequently hidden from the investor. We have therefore recommended that competent authorities consider the introduction of a single investment management charge. All other intermediation costs, charges and expenses incurred by the investment manager, including transaction costs, should be borne directly by the firm (not the fund) and reflected in the single charge.

Such a change would require firms to price their services in a way that they remain profitable yet competitive, and provide a like-for-like cost comparison for investors.