Financial Conduct Authority

MS15/2.2: Annex 1

Market Study

Asset Management Market Study

Interim Report: Annex 1 – Views from stakeholders on the Terms of Reference

November 2016

Annex 1: Topics raised by respondents

We received over 30 written responses from a range of organisations, including asset managers, investment consultants, industry bodies and consumer organisations on the topics raised in our terms of reference.

- Most respondents welcomed our market study and many of the comments were consistent with the areas we are looking at as part of the market study.
- Several respondents suggested that we expand the scope of the study to include financial advisors and firms passporting into the UK.
- Some responses highlighted the importance of platforms and investment consultants as a distribution channel for assessment management products and their impact on competition in the asset management sector.
- In our approach to assessing value for money, some respondents asked that we consider factors other than just fees and charges. Similarly, when considering how asset managers procure ancillary services, some suggested that we should focus on quality as well as costs.
- Respondents also cited examples of recent innovation in the asset management sector and regulations that, in their view, act as barriers to entry and expansion.
- We used the insights gained from the responses to feed into our analysis and inform our assessment of the issues.

1. In this annex, we summarise the issues raised in the responses. In general, most of the responses welcomed our decision to launch a market study into the effectiveness of competition in the asset management sector. Even where respondents took the view that asset managers were competing effectively on price and quality, they pointed to other parts of the asset management value chain which they thought merited an in-depth look. We took on board the comments received and, where possible and practical incorporated them into our analysis.
2. In the sections below we consider the comments made by respondents on specific issues along with our observations.

Product and geographic scope

3. Several respondents suggested that we should consider funds domiciled abroad passporting into the UK in our analysis of the sector because they are part of the

UK's competitive landscape. In their view, the dynamics of competition and consumer protection in the UK could not be analysed solely from a UK client and UK supplier perspective. Some respondents cautioned that failing to do so may reduce the international competitiveness of the UK asset management industry and discourage new entrants from domiciling their funds in the UK.

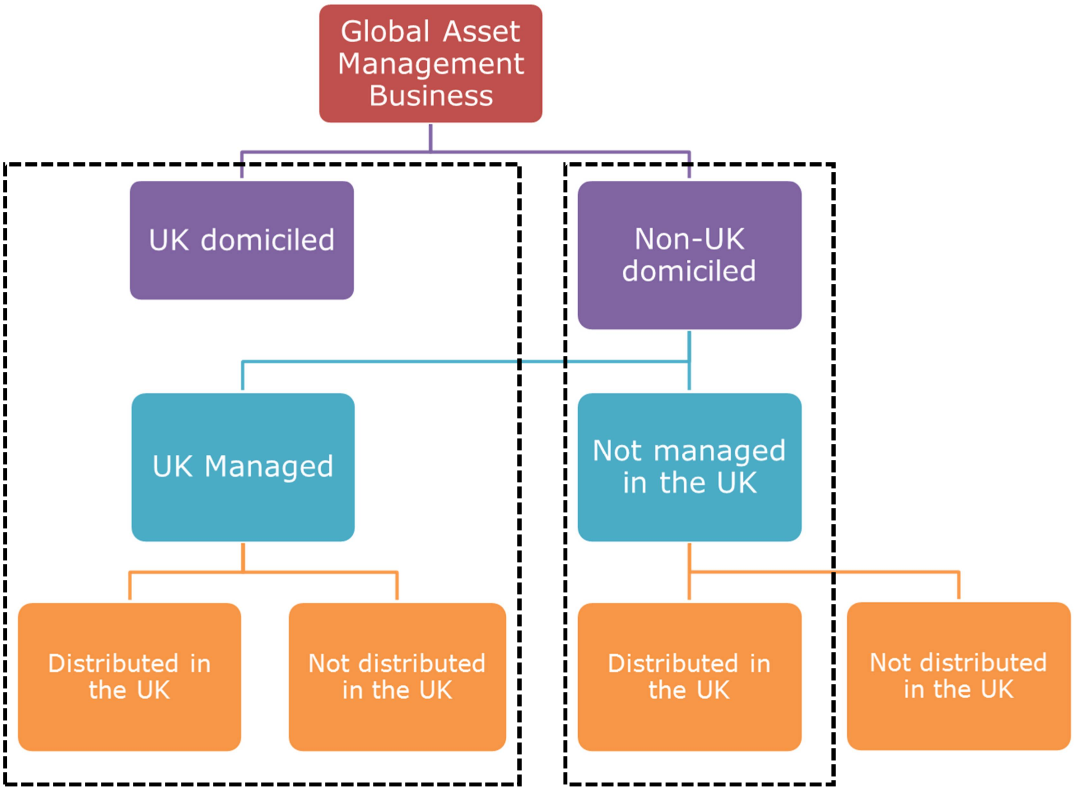
4. Several respondents commented that the scope should be widened to include financial advisors including wealth managers, independent financial advisors and stockbrokers because of their role as intermediaries in the asset management sector. They pointed out that fees charged by distributors formed part of the end-price paid by investors for the asset management product, and so should be considered as part of any assessment of value for money in the retail sector.

5. Some respondents also suggested that the market study should consider private equity funds, hedge funds, absolute return funds and other fund structures investing in 'alternatives', because of the increasing trend of pension funds investing in these strategies. We noted these comments and expanded our scope to include hedge funds and Absolute Return Funds in our study.

6. One respondent also suggested that with-profit insurance products should be brought more explicitly within scope. This was because, even though these products are not now widely sold, the legacy assets under management of these products on behalf of retail investors are significant. We noted concerns raised about with-profit products. However, the focus of the market study was on asset management products and those that are potential substitutes.

7. We recognise that distributors of asset management products, such as financial advisors, have an impact on competition between asset managers. While financial advisors were not the main focus of our market study, we did some work to understand the role of financial advisors in the retail distribution chain. Please see chapter 5 which sets out our findings in relation to retail distribution

8. In terms of the geographic scope of the market study, we considered firms domiciled in the UK, and funds managed and marketed to UK investors. We wanted to capture products sold to UK investors by firms based in the UK. As part of this we wanted to include retail investment products offered by providers domiciled abroad. The diagram below sets out geographic scope of the products we considered- funds within the dotted lines were considered as part of the market study,



Value for money

9. Most respondents said that any assessment of value for money in this sector cannot only look at fees and charges, and agreed that this was acknowledged in the terms of reference. Respondents asked that the market study continue to consider the broader constituents of value rather than have a narrow focus on cost. Some suggested that an accurate measure of what represented value for money would include a consideration of risk, service, performance, suitability, flexibility and innovation.

10. Some of the responses said that asset managers compete intensively on price which has resulted in lower fees for investors – and a significant reduction in revenues and margins for asset managers. However, they pointed out that a reduction in asset management fees may not always be passed on to end investors. Respondents acknowledged that charges vary across the sector, for example, between active and passive investment strategies, and retail and institutional investors, but in their view this reflected and was driven by the sophistication of underlying strategies, transaction costs and likely retention periods.

11. While most respondents welcomed the idea of more transparency, a few cautioned that enhanced disclosure would be of limited value, and might even create confusion and misleading signals, if investors were not sophisticated enough to fully understand the information they were given. These respondents suggested that, in order to drive effective competition, greater transparency needed to go alongside access to financial advice and education for investors. One respondent noted that additional disclosure alone would not be enough to eliminate issues around alignment of incentives, behavioural bias and consumer disengagement.

12. The responses also pointed to the role of investors, both institutional and retail, in driving value for money. Responses cited a fragmented investor market where most investors were relatively weak negotiators. Respondents said that behavioural bias in the UK appears to suggest that investors remain more influenced by past performance than fund cost. Costs are still more of a focus for US investors than they are for investors in Europe. Some of the responses also commented on the role of investment consultants in driving value for money. One respondent said that decision makers on the institutional side that make investment decisions on behalf of others have very limited incentive to demand value for money.

13. Some of the responses also said that investors may not be sufficiently informed about the level of risk they are taking. It was suggested that the focus on returns without adequate consideration of risk incentivised managers to maximise returns and ignore risk. One respondent gave the example of how very little time is spent during the asset allocation process by investment consultants in explaining the levels of risk to trustees.

14. As part of our market study we considered how investors make investment decisions and factors that influence their choice of products and providers. Our findings are set out in chapter 4.

Investment Consultants

15. A number of respondents referred to investment consultants as ‘gatekeepers’ to the institutional asset management sector and welcomed our decision to look at investment consultants as part of this market study.

16. Several respondents pointed to the small number of investment consultancy firms and the significant influence they appear to exert on the decision making of institutional investors and pension funds in particular. Some respondents said that limited competition among investment consultants affected competition in the asset management sector. This was because some consultants wanted to deepen existing relationships with their preferred asset managers instead of encouraging new firms.

17. One respondent suggested that the reluctance to include new asset managers was partly also because of the resource constraints on investment consultants. The level of fees paid to consultants for research encouraged them to minimise the number of managers they research. It was not possible to fully research all asset managers and there was little financial incentive for them to research ‘challenger’ firms in core asset class areas.

18. The potential for conflicts where investment consultants move into fiduciary management was also raised, particularly for Defined Benefit pension schemes. Some responses suggested that the potential for conflicts in Defined Contribution schemes is also high, especially if consultants advising clients have financial arrangements with asset managers.

19. Some respondents suggested that there should be greater transparency on how investment consultants work, in particular how they rate managers and their role in the manager selection process for their clients. Respondents also said that a comprehensive feedback system for asset managers when they are not able to win a mandate would lead to asset managers ‘improving, innovating and challenging the

status quo'. According to one respondent in some cases, feedback is made available to asset managers, but only for a charge.

20. The insights provided by the respondents were considered as part of our analysis, and our findings are set out in chapter 8.

Platforms

21. Respondents told us that platforms play an increasingly significant role in the sector as they become an important distribution channel for retail investments. Some respondents told us that it could be difficult to market a fund not on one of the major platforms. Some respondents suggested that the recommendation and ratings made by platforms on their 'best buy lists', which can influence investors' choice of products, tend to cluster around the same products and funds.

22. One respondent said that competition between platforms should be brought into scope, otherwise it would not be possible to properly assess how prices at the retail level are set and how retail investors make purchasing decisions. Platforms hold data on the investors using their platform and so have a thorough understanding of the behaviour of end-investors, as they can see fund flows that asset managers might not. It was suggested that if this data was made available to asset managers, it would help better understand consumer behaviour, increase competition and innovation, and put managers in a better place to meet customer expectations.

23. Several responses pointed to the complexity of platforms' charging structures. According to respondents in some instances the fund charges displayed on a platform (such as the annual management charge) were not just the asset managers' fees but also included distribution costs.

24. A few respondents highlighted the positive impact that platforms had on the sector, for example, where they use their buying power to negotiate better prices. Respondents suggested that platforms have also made it easier for investors to consolidate their investments and take advantage of tax wrappers such as ISAs and SIPPs.

25. Respondents noted possible benefits of vertical integration of asset managers and platforms, including lower charges due to lower costs and the sharing of market expertise. However, some respondents also said that risks around conflicts of interest increased with vertical integration. In terms of business models, one response said that vertically integrated providers may be at an advantage as they were able to retain a higher percentage of product charges compared to asset managers that did not have a platform of their own.

26. The insights provided fed into our analysis and understanding of the market. See chapter 5 on retail distribution where we set out and discuss our findings.

Ancillary service providers

27. A number of respondents said that asset managers may not be incentivised to control costs paid out from the fund. One respondent said that some asset managers may not choose the best provider for a particular service if the provider did not offer a bundled service, and that any savings due to bundling or related to scale were not always passed on to end investors.

28. Some of the asset managers responding to the terms of reference disagreed saying that incentives of the asset manager were aligned with the client because ultimately fees for ancillary services charged to the fund negatively impact on the asset manager's performance. Asset management firms said that when choosing an ancillary service provider they balanced the cost of the service with the need to minimise operational risk and ensure a high quality service. It was noted that an asset manager's ability to control costs of some ancillary services was limited as a result of competition in those markets and in the majority of cases, asset managers were only 'price takers'. A number of responses suggested that we should include benchmarking and index data providers as part of the market study.

29. Some respondents said that many suppliers of ancillary services compete quite aggressively on cost as a differentiating feature. One respondent said that this could result in ancillary service providers cutting costs and discouraged them from investing in appropriate systems and controls.

30. The emergence of third party service providers was cited as a positive development which helped to lower set-up costs and reduce the level of capital required for new asset managers looking to enter the sector. Although one respondent said that custodian costs for smaller firms were still very high.

31. The responses helped us identify an area we had not previously made an explicit focus of our market study, which was the provision of benchmarking and index data. This was raised by a number of asset management firms as an area where, in their view, further investigation would be welcome. As a result we expanded our scope to include benchmarking and index data when examining ancillary services related to asset management.

32. We said in our terms of reference that we would only consider ancillary services to the extent that they have an effect on the provision or consumption of asset management products and services but would not undertake an in-depth investigation of the effectiveness of competition in individual markets for ancillary services. We set out our findings in relation to this in chapter 7.

Product innovation and regulatory barriers

33. Respondents said that there had been investment and innovation by the industry for the benefit of customers and cited the development of LDI strategies, diversified growth funds and smart beta strategies as a few examples of innovation in this sector in recent years. They also pointed to the investment in recent years in research, trading and other systems to ensure that funds can be traded efficiently and securely. It was suggested that developing areas in the sector included blockchain, 'big data' and other FinTech initiatives, although one respondent said that the intermediation of asset managers can lead to less innovation reaching the market. This positive view was not shared by all respondents. It was suggested that investment in systems and infrastructure across the industry was poor and that technology is not used as effectively or widely as in other industries.

34. We received mixed comments around the regulatory regime. In general, respondents welcomed the incoming legislation which would enhance transparency around transaction costs. A few respondents said that some provisions of investor protection regulations, such as the AIFMD and UCITS V, negatively impact smaller asset managers by increasing regulatory requirements. Smaller asset managers do not have the 'in-house infrastructure' to satisfy these requirements and therefore are

more reliant on investor servicing firms, which pushes up their costs. For small and mid-sized asset managers, regulatory compliance costs and overheads act as a barrier to entry and a barrier to delivering returns to their clients. One respondent advocated easing some of the regulatory reporting and other regulatory requirements applied to those managers which solicit only institutional capital.

35. The insights provided by the responses were very useful and were considered as part of our analysis. In chapter 9 of our report we discuss examples of innovative developments in this sector and how regulation impacts asset management sector.

Other issues raised

36. Some of the other issues raised in the responses are summarised below.

37. **Business models.** Some responses supported our decision to look at the profitability of asset managers. Other respondents said that this should not be an area of interest for the market study as profitability and margins for asset management firms had declined in recent years. One respondent said that the market study should avoid making judgements on different business models and investment strategies while another said that we should explore the correlation between remuneration strategies and market behaviour. We discuss this in chapter 6 and, in more detail in annex 8.

38. **Active v Passive strategies.** A few of the responses cautioned that a discussion on value for money should not lead to the conclusion that passive products are always better for retail investors than actively managed investments, or that cost should be the sole determinant when choosing between active and passive investment strategies. A few asset managers highlighted the value that a well-managed active strategy can deliver for investors.

39. **Benchmarks.** Respondents highlighted that in order for investors to effectively compare between asset managers, it is important that the performance of funds and/or managers is sufficiently comparable. Where asset managers use indices as a performance benchmark, often determining their performance fees against that benchmark, it is important that the benchmarks are sufficiently independent. The use of Investment Association's sector classifications to assess relative performance was also discussed. These sectors are not tightly defined which makes it much harder to determine how much value is added by stock selection when returns are muddied by asset classes.

40. The insights provided by respondents on these topics informed our thinking and analysis. We refer to some of these issues in Chapter 4.

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