COVINGTON

FCA Publishes Its Interim Report on Its Asset Management Market Study

28 November, 2016

Financial Services and Regulation

On 18th November 2016, the Financial Conduct Authority ("FCA") published its long-awaited Interim Report setting out the findings of its asset management market study ("the Report"). The Report identifies issues and concerns regarding whether the market is providing value to customers, both in the retail and institutional sectors and the FCA has found evidence which suggests that there is weak price competition in a number of areas of the asset management industry.

Background

The UK's asset management industry manages nearly £7 trillion of assets, in the institutional and retail sectors. This makes the industry the second largest in the world. Over three quarters of UK households with occupational or personal pensions use the services offered by asset managers. In November 2015, the FCA launched its study of the asset management market, in order to assess whether competition is working effectively. It looked at whether institutional and retail investors are provided with good value for money, when purchasing asset management services in both the retail and institutional sectors.

Key issues

The Report runs to a full 208 pages, in which the FCA highlights a number of key issues, together with proposed remedies. Key issues include the following findings by the FCA:

- Investors often pay high charges for actively managed funds, with these costs not being justified by higher returns.
- Over the past five years, charges for actively managed funds have stayed much the same, whilst charges for passive funds have fallen. However, whilst there appears to be stronger competition on price for passively managed funds, the FCA did find some examples of poor value for money in the sector.
- Firms are reluctant to undercut each other by offering lower charges to attract investment, particularly in relation to retail investors.
- There is considerable price clustering for active equity funds, with many funds priced at 1% and 0.75%, particularly where assets under management are greater than around £100 million.
- Prices do not fall as fund size increases, which suggests that the economies of scale are captured by the fund manager, rather than being passed onto investors in the funds.

- The objectives of funds are not always clear and performance is not always reported against an appropriate benchmark. Although improvements have been made in market transparency, the FCA is nevertheless concerned as to how asset managers communicate objectives and outcomes to investors. Investors may continue to invest in expensive actively managed funds which mirror the performance of the market, purely because fund managers do not adequately explain the fund's investment strategy and charges.
- The FCA identified two concerns with absolute return funds:
    1. many absolute return funds do not report their performance against the relevant returns target; and
    2. the FCA has concerns about absolute return funds that charge a performance fee when returns are lower than the performance objective the fund is aiming to achieve. The manager is rewarded, despite not achieving what the investor may expect to be the target performance.
- The FCA looked at the factors driving the choice of asset manager by both retail and institutional investors, as well as their ability to negotiate with asset managers. The FCA found that generally, customers do not manage their investments actively.
- Engagement with asset managers by both retail and institutional investors tends to be poor. Retail investors do not usually negotiate directly with asset managers and the governance bodies acting on their behalf typically do not focus on value for money. On the institutional side, there are a large number of small pension schemes and trustees which vary in how effective they are at negotiating price.
- Asset management firms find that where they create new share classes, they find it difficult to switch investors to these new classes, even though they are cheaper and it would be in the best interests of investors. This is because they currently need the investor's consent to transfer them to the alternative share classes and many investors do not respond to communications.
- The FCA has considerable concerns as to the value provided by platforms and advisors. The FCA is proposing further work in this area.
- The investment consultancy market is relatively concentrated, with the top three firms accounting for around 60 percent of the market. Levels of switching in the market are low—90 percent of investors surveyed had not switched consultant in the last five years. In addition, many institutional investors struggle to monitor and assess the performance of the advice they receive, and whether investment consultants are acting in their best interests. Accordingly, the FCA has concerns as to whether the interests of investment consultants are in line with investors' interests. Accordingly, the FCA is proposing further investigation and is consulting on making a market investigation reference to the Competition and Markets Authority on the investment consultancy market.

Proposed package of remedies

The FCA is proposing a significant package of remedies in order to address these concerns. The FCA says that these remedies will seek to make competition work more effectively in the asset management market and will protect those least able to engage actively with their asset manager. The remedies include the following.

- A strengthened duty on asset managers to act in the best interests of investors, including reforms to hold asset managers to account for how they deliver value for money.
- Introducing an all-in fee, so that investors and funds can easily see what is being taken from the fund.
- A number of measures aimed at helping retail investors identify which fund is right for them. These measures include requiring asset managers to be clear about the objectives of the fund, clarifying and strengthening the use of benchmarks and providing tools for investors to identify persistent underperformance.
- Making it easier for retail investors to move into better value share classes.
- Requiring clearer communication of fund charges and their impact at the point of sale and in ongoing communication to retail investors.
- Requiring increased transparency and standardisation of costs and charges information for institutional investors.
- Exploring the potential benefits of greater pooling of pension scheme assets.
- Requiring greater and clearer disclosure of fiduciary management fees and performance.

Market investigation reference

The FCA is also consulting on whether to make a market investigation reference to the CMA on the investment consultancy market. Market investigations are detailed examinations as to whether there are features of a market that result in an adverse effect on competition. These investigations are conducted under Part 4 of the Enterprise Act 2002. Any market investigation has to be completed and a report of the investigation published within 18 months of the date of reference. The CMA has extensive powers to take action where it finds any adverse effect on competition. It may impose an Order or require undertakings to be made and may put remedies in place addressing the structure of the market directly, or which address the behaviour of market participants, such as improving transparency.

In addition, the FCA has recommended that HM Treasury considers bringing the provision of institutional investment advice within the FCA's regulatory perimeter. The FCA is also undertaking further competition work on the retail distribution of funds, particularly in relation to the impact of financial advisers and platforms on value for money.

Next steps

The FCA is requesting responses by 20 February 2017. In the meantime, it is seeking views on its interim findings and says that it is welcoming "views from all stakeholders on the emerging thinking on potential remedies."

If you have any questions concerning the material discussed in this client alert, please contact:

Charlotte Hill +44 20 7067 2190 chill@cov.com