Transaction costs disclosure

Improving transparency in workplace pensions

Introductory comments

NEST welcomes the opportunity to contribute to this important topic, particularly as we place a high value on transparency.

NEST has identified three key points.

- We ultimately believe that the issues at stake are those of governance. As such, these issues cannot be addressed by transparency around identifying and analysing transaction costs alone.

- We do not expect that schemes providing detailed transaction cost information to members and employers will empower savers to make better decisions about their retirement savings. We also do not expect this information to lead to employers making any more appropriate scheme choices than they already are. However, we do believe that the industry needs to develop ways to communicate this more effectively and other technical information to members in a meaningful way. This, however, is contingent on the information being available in a standardised format.

- We need to be wary that the costs of gathering detailed transaction costs are likely to lead to increased costs for schemes. These costs are likely to be passed on to savers and so we need to be clear that the benefits justify the increased costs. It is important to remember that it is the net returns to savers which are a key determinant of the good outcomes for members.

We believe that savers ought to reasonably expect that the governance body choosing investments on their behalf should understand the transaction costs of their fund managers. This should be the case whether that governing body is a trustee board or an independent governance committee (IGC) who should be able to reassure savers that transaction costs are reasonable and appropriate, whatever other transaction cost information is provided.

We are concerned about the potential for creating a prescriptive and potentially over-complicated process for analysing transaction costs.

In our experience, information on transaction costs is generally accessible. We would argue that what governing bodies do with this information to understand and monitor transaction costs is more important than having a rigid approach to disclosing these costs.

When choosing a fund manager, we believe that it is best practice for the governance group to already have amongst its selection criteria the following factors.

- Is the investment time horizon of the fund appropriate for the scheme's members? (Portfolio turnover levels provide a very good indicator of this).

- Does the investment strategy have the capacity to be implemented effectively for the manager to meet its investment objectives?

- Following on from this, is the cost of transacting, and in particular the market impact of investing, overwhelming the potential for generating alpha?

- Are there hidden costs for which members are paying? If so, what are they and how can they be controlled or eliminated?

Governance group bodies should reasonably ask for and monitor line-by-line transaction costs. These costs include brokerage fees, stamp duty and market impact cost, but these will vary depending on asset class. Any fit-for-purpose manager selection and monitoring process will give an understanding of whether transaction costs are likely to be an issue of concern to a governing body.

For example, a passive manager tracking an index has an inherent challenge to match or beat the benchmark as the index will not include any transaction costs. A passive manager has very strong incentives to minimise transaction costs at every level in order to minimise the negative tracking error on which their performance will be judged. Even in the active space, it is not our experience that managers will deliberately churn a portfolio. It may be that the strategy naturally leads to high turnover. However, the governing body ought to be informed about the investments being used to execute a strategy.

In general, private market investments with uninvestable benchmarks are more likely to have higher transaction costs. For this reason it is possible they may require closer scrutiny.

However, any framework that risks polarising options with higher transactional costs against those with lower will not be to the benefit of the scheme. Transaction cost information needs to be looked at in the context of the total offer the saver receives as a result of a particular investment strategy.

Many pension schemes invest in a range of investment structures. These include unit-linked pension funds, hedge funds, ETFs and UCITS, domiciled in the UK, Ireland or Luxembourg. Unless there is also a requirement for all products and providers to provide information in a consistent manner and using the same definitions it will be very difficult for all pension schemes to comply with the proposals put forward.

Smaller schemes in particular may struggle to get hold of information they need given the different regulatory frameworks for different investment structures and the lack of clout they may have when requesting information compared to larger schemes.

We believe governing bodies should be able to demonstrate that they either have the ability, or they have advisers with the ability, to carry out the appropriate analysis. This analysis should be integral to the manager selection and monitoring process.

To conclude, transaction costs are an important issue and an integral part of delivering good value for money for members. Transparency is also important. However, it is vital that the disclosure regime enables those in the investment chain to deliver comparable contextualised information at a sensible cost.

NEST responses to questions

NEST has responded to a selection of the questions where we believe we can offer an informed opinion. We have also provided general comments where we felt this was the best way to contribute to a topic.

1	**Should the requirements for standardised, comparable disclosure of transaction costs apply only to those schemes that will be subject to the new governance and charges measures from April 2015? If not, are there differences that should be taken into account when considering transparency in other schemes?**		We have no comments to make.
2	**What are the advantages and disadvantages of capturing and reporting bid-ask spreads?** **Do you have any views on the ease of identifying bid-ask spreads, or modelling them?** **What practical challenges are there in calculating bid-ask spreads?** **Do you have any views on estimation models of bid-ask spreads?**		**What are the advantages and disadvantages of capturing and reporting bid-ask spreads?** Although bid-ask spreads are implicit costs, they should be captured as they are a cost of trading. They are also an important factor in the case of bonds as the trading costs associated are paid via the spread. **Do you have any views on the ease of identifying bid-ask spreads, or modelling them?** For schemes investing in pooled funds, managers calculate spreads as part of their valuation/pricing mechanism each business day. Projecting future spreads is more difficult. Fund of funds investing in underlying funds will tend to be single priced based using the prevailing price of the underlying funds. You can calculate an implied spread for the fund of funds based on the underlying and asset allocation but rarely would the fund of funds flip from a full offer price to a full bid price.

3	**What are the advantages and disadvantages of capturing and reporting market impact?** **Do you have any views on the ease of identifying market identifying market impact costs?** **What practical challenges are there in calculating market impact costs?** **Do you have any views on the possible estimation models of market impact?** **Do you have any views on the availability of these models, their consistency, and the costs providers charge to access them?**		**What are the advantages and disadvantages of capturing and reporting market impact?** **Do you have any views on the ease of identifying market identifying market impact costs?** We do not agree that market impact costs should be included within transaction costs. As these costs are implicit, there will always be a degree of interpretation involved. **What practical challenges are there in calculating market impact costs?** While there is an argument for disclosing and monitoring market impact costs we are concerned that the cost of this exercise would ultimately be passed on to savers. **Do you have any views on the possible estimation models of market impact?** Calculating market impact costs is arguably as much an art as a science with different service providers using different methodologies. This means gaining ‘apples to apples’ comparisons is next to impossible. **General comments** • Market impact costs can sometimes be negative which means you can have negative transaction costs if you include these within the transactions costs. This is another reason for excluding them from transactions costs. • Fund managers are regulated to get best execution and it is the role of their regulator to ensure they are executing trades appropriately. • It is very difficult, if not impossible, to predict future costs.

4	**Do you believe that missed trade "opportunity costs" and "delay costs" are transaction costs?** **Do you believe that there is merit in reporting them as part of the disclosure regime and in governance bodies reviewing them?** **Do you believe that the practical issues, for example around the subjective nature of some of the inputs needed to calculate them could be addressed?**		**General comments** Similarly to market impact costs, we are not sure how it will be possible to assess these costs systematically and consistently. There will be practical and subjective issues trying to capture these costs which we believe means they should be excluded from transaction costs. Again, ensuring best execution is the role of the regulator. **The pension scheme or asset owner governance group should do due diligence to ensure the incentives, processes and resources are in place to deliver good dealing outcomes.**
5	**Do you have any further thoughts on the analysis of transaction costs outlined in this chapter?** **Are there any alternative approaches to identifying transaction costs, or other considerations to take into account?**		Property funds and infrastructure funds do not appear to have been in scope of the call for evidence.
6	**Do you have any comments about the different frameworks within which information might be reported and their respective strengths and weaknesses?**		As a pension provider, we receive the information by underlying asset classes, funds and managers. We see no advantage reporting by employer. With potentially hundreds of thousands of employers in NEST, it would involve significant resources that would ultimately need to be borne by our members and/or their employers. **General comments** We have concerns about how this information is reported to members and employers as there is much scope for misunderstanding. The issues with providing this information at a product (member fund) level are layered. In a fund of fund structure with asset allocation changes between reporting periods, there will be issues around timing. Underlying funds will have different reporting periods and will not necessarily be synchronised with the scheme's year end. Without fund providers having an obligation to provide the

			information it may be difficult and/or costly to comply, particularly as schemes invest via many different structures such as unit-linked life funds, and UCITS variously domiciled in different territories.
7	**How should transaction costs incurred at product level be captured and reported?** **Would there be merit in splitting out costs incurred for different reasons? How could this be achieved in practice?** **Are there any other costs incurred at a product level that are not administration charges, and that could potentially be considered transaction costs?**		**General comments** Fund of funds/multi asset class structures present particular challenges in terms of capturing and reporting transaction costs. It may be easier to consider for each asset class, but aggregating to total fund level will be difficult and difficult to explain to investors. We see it as our role, as the Trustee, to ensure that transaction costs are appropriate. There would be value in giving an assurance statement to members that their product/fund transaction costs have been scrutinised and are reasonable. Governing bodies should be able to provide evidence of this scrutiny to the regulator.
8	**Do you have any views on whether pension schemes should be required to look through to the transaction costs of all listed, exchange-traded investment schemes?** **Do you have any particular comments on how the transaction costs incurred by property, (and other real asset investments), private equity and hedge funds should be identified and disclosed?** **Is separate guidance needed on how to disclose transaction costs in these areas, or can the principles used in securities markets be applied?**		**Do you have any views on whether pension schemes should be required to look through to the transaction costs of all listed, exchange-traded investment schemes?** There are significant practical and cost issues associated with this. The cost and difficulty of trying to look through, for example, ETFs which are likely to have small weightings in portfolios would far outweigh any potential advantage. **Do you have any particular comments on how the transaction costs incurred by property, (and other real asset investments), private equity and hedge funds should be identified and disclosed?** In property and infrastructure there are definitional issues to be addressed as to what a transaction cost is and what is a member borne deduction (MBD). In addition, there are costs which are associated with the holding of the assets and servicing the assets we do not believe fall into transaction costs or MBD.

			In addition there is an issue with considering REITs on a look-through basis as a number of property companies are established as REITs for tax efficiency purposes and are not funds in the real sense (and this information is not readily available).
9	**Do you have any comments on the treatment of derivatives? Should the costs of derivatives be disclosed separately somewhere within the disclosure reports? Do you have any comment about the transaction costs associated with structured products?**		**Do you have any comments on the treatment of derivatives?** Transaction costs in relation to derivatives should be disclosed.
10	**Do you have any views on the different approaches to calculating transaction costs?** **Do you agree that a principles-based approach is appropriate to set how transaction costs should be reported for each type of asset?** **Do you have any comments on the reporting of negative transaction costs?**		**Do you have any views on the different approaches to calculating transaction costs?** Our preference would be to use actual costs rather than some form of model. **Do you agree that a principles-based approach is appropriate to set how transaction costs should be reported for each type of asset?** We believe prescriptive regulation is not a substitute for good governance in this context. There is a significant risk of over-complication and over- elaboration around approaches to calculating transaction costs. **Do you have any comments on the reporting of negative transaction costs?** Negative costs can occur when market impact is reported. This is an argument for excluding them from transaction costs and treating them separately.
11	**Should portfolio turnover rates be reported alongside transaction costs? If so, do you have any comments on the best methodology to use to ensure comparability of portfolio turnover and transaction costs?**		It is useful to report portfolio turnover rates (PTR) alongside transactions costs. PTRs are highly correlated with levels of transaction costs. For some savers and employers this may be the best proxy as to what the transaction costs are likely to be. There are issues with the different ways of measuring turnover. However, as the IMA concluded in its paper[1] 'it would appear that in practice, and since investors will wish to observe changes in the PTR over times and relative PTRs between

[1] Meaningful disclosure of costs and charges

			otherwise similar funds, it may make little difference which method is used'.
12	**Do governance bodies need risk and return information to be reported alongside transaction costs, or is it sufficiently readily available to them from other sources, considering the balance of costs and benefits that such new requirements may impose?** **If you think risk information should be reported, do you have any feedback on the best risk measures to use when considering transaction costs?**		**Do governance bodies need risk and return information to be reported alongside transaction costs, or is it sufficiently readily available to them from other sources, considering the balance of costs and benefits that such new requirements may impose?** For schemes such as NEST that have their own in-house investment teams, there is unlikely to be the need for any new requirement.
13	**Do you have any views on the value and/or costs of benchmarking?** **Are there any other issues to be taken into account when exploring benchmarking?**		**Do you have any views on the value and/or costs of benchmarking?** There may be value for benchmarking but there are issues about comparability given the differences between schemes and their objectives for their respective memberships. Also there are cost considerations. Ultimately these will be borne by the saver. For this reason we have to be sure that the additional expense is creating value and better outcomes for members.
14	**Do you have any feedback on the reporting of the costs of securities lending, foreign exchange and related activities, and on how these should be reported?** **Are there any other areas or practices that you would highlight where providers are imposing additional costs or generating "hidden" revenues?**		**Do you have any feedback on the reporting of the costs of securities lending, foreign exchange and related activities, and on how these should be reported?** For NEST's part, the income from is reported net of costs. However we also get the split between revenue and costs which is sufficient for our needs. Of more importance is whether the revenue split between member and fund manager is fair. **Are there any other areas or practices that you would highlight where providers are imposing additional costs or generating "hidden" revenues?** We are not aware of 'hidden' revenues. This may be more of an issue in private equity structures.

15	**Do you have any comments on the practical issues with presenting costs and charges information?** **Do you have any comments on the degree of standardisation that will both enable governance bodies to take decisions on their scheme and achieve comparability across the market?** **Are there any other factors in the presentation of transaction costs in a report that would enable governance bodies to make better decisions?**		**Do you have any comments on the practical issues with presenting costs and charges information?** In terms of trustee boards and IGCs there are no practical issues with presenting costs and charges information. **Do you have any comments on the degree of standardisation that will both enable governance bodies to take decisions on their scheme and achieve comparability across the market?** Standardisation will be useful for requesting the information from managers.
16	**Do you agree with the use of portfolio turnover rates and unit transaction costs to enable better prediction of likely transaction costs?** **Should providers be required to provide reasons if turnover rates are likely to be different in the forthcoming period?** **Is there any other information that would enable the governance body or scheme members to understand potential future transaction costs?**		**Do you agree with the use of portfolio turnover rates and unit transaction costs to enable better prediction of likely transaction costs?** Any historic numbers are at best a rough guide to future transaction costs. Before requesting predicted transaction costs or turnover rates, it is important to understand the consequences. These are not an absolute number as future flows and market conditions may impact future turnover numbers.
17	**Do you have any comments on whether a transaction cost disclosure regime will have any other consequences for the way that pension schemes and their agents transact?**		The biggest difference between transaction costs for different schemes is the relative use of active and passive managers. If schemes believe that the higher costs of active management are justified, then the transaction costs disclosure regime will have little or no impact.

18	**Should regulations and rules on transaction cost disclosure only directly apply to pension providers and trustees?** **If not, on whom would additional disclosure requirements be necessary to ensure that transaction costs are reported accurately to relevant people?**		**Should regulations and rules on transaction cost disclosure only directly apply to pension providers and trustees?** There could be a benefit for these rules to apply to fund managers. Large schemes will be in a stronger position to ask for this information than some smaller pension schemes.

			However, this leads to the question about how this would be enforced. For example, would it form part of the FCA's conduct regime?
19	**What information on transaction costs would be useful to employers and members? How and when should this be reported to them?**		**General comments** • The Occupational Pensions Scheme (Charges and Governance) Regulations 2015 sets out rules for some disclosure. In the Chair's Annual Governance Statement (Par 17) 23 (C) in relation to the charges and transaction costs which the trustees or managers are required to calculate in accordance with regulation 25(1) (a) of these Regulations. (i) State the level of charges and transaction costs applicable to the default arrangement during the scheme year or, where the scheme has more than one default arrangement, state the range of the levels of charges and transaction costs applicable to those arrangements. (ii) State the range of the levels of charges and transaction costs applicable to all funds which are not part of the default arrangement and in which assets relating to members are invested during the scheme year. (iii) Indicate any information about transaction costs which the trustees or managers have been unable to obtain and explain what steps are being taken to obtain that information in the future. (iv) Explain the trustees' or managers' assessment, in accordance with regulation 25(1) (b), of the extent to which the charges and transaction costs represent good value for members. • We do not expect that schemes providing transaction cost information in the way proposed will empower savers to make better decisions about their retirement savings. We also do not expect this information to lead to employers making any more appropriate scheme choices than they already are.

			• The costs of gathering transaction costs in the ways proposed are likely to lead to increased costs for schemes. These costs are likely to be passed on to savers. • Any transaction information should be credible, comparable and provided in context. That context should be the investment objectives of a scheme or product and why the investment strategy chosen to meet those objectives is considered appropriate.
20	**What information on costs and charges should be made publicly available? When and how should this be information be provided?**		Please see comments in response to Question 19.
21	**Are there any areas that you would highlight where firms, trustees or asset managers may not comply with the disclosure regime in the way intended?** **If you are concerned that this may be the case, are there steps that could be taken to reduce the incentive to get around reporting transaction costs?** **Would third-party oversight of reports enhance their value and usefulness?**		**Would third-party oversight of reports enhance their value and usefulness?** There are two existing regulatory bodies in this space, the FCA and TPR, in addition to the requirements on assurance statements. Master trusts have to complete an 'Assurance reporting on master trusts (Master Trust Supplement to ICAEW AAF 02/07)'. This is the independent assurance framework that requires an independent reporting accountant. One of the assurances that have to be given is 'Assessment of value for money'. It requires that members participating in a master trust should receive value for money and that costs and charges should be commensurate to the quality of pension provision offered to the membership. In light of the existing regulatory apparatus, we would be concerned about the creation of any addition oversight body or framework. The more onerous the compliance regime, the greater the pressure on the consumer detriment to earn back the associated costs.
22	**Do you have any comment on the likely costs involved in implementing transaction cost disclosure along the lines described in this call for evidence?**		Please see comments in response to Question 21. We expect costs could be significant. The more complex and onerous the regime, the more savers will end up paying.