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Transaction Costs Disclosure: Improving Transparency in Workplace Pensions – Call for Evidence

KAS BANK N.V. is a European specialist custodian, risk reporting agent and fund administrator to Pension Funds and Institutional Investors with over 200 years' experience. With Assets Under Administration of EUR505bn, KAS BANK works with a third of pension schemes in the Netherlands and has an increasing pension fund client base in the UK. We worked collaboratively with the Pensioen Federatie in the Netherlands to shape transparency regulation and are well versed in providing Dutch regulatory reporting for the Financial Assessment Framework (FTK). Our experience means that we feel able to provide useful input into the development of further transparency around costs in the UK.

We believe transparent collection of costs is important for UK pension schemes as costs span much further than purely the reported AMC, and these costs are generally absorbed by the return of the fund. In the current scenario where DB scheme funding levels are under pressure due to a low yield environment, the impact of costs on the sustainability of these pension funds is considerable. We believe that if you are able to measure costs more reliably and consistently, you can input this information to establish true performance, in order to make more educated decisions and empower trustee boards to be in control. Ultimately cost collection should not pose a challenge to enforce through regulation as the data belongs to the underlying pension fund. However, we recognise that it may be technically challenging for asset managers to provide a look through into funds on a line by line basis to estimate transaction costs at a consolidated level. The Dutch model shows that the ultimate ownership of data by the pension fund means that it is collectable.

Key challenge: Currently there is no mandated collection of data in the UK

- There are voluntary codes of practice, for example IMA disclosures, however nothing that is standardised and regulated
- However, there is a proven data collection method in the Netherlands, created by the Pensioen Federatie and regulated by their regulator - de Nederlandsche Bank (DNB)
- The Financial Assessment Framework (FTK) format collects far more than costs, but nevertheless annual cost reporting plays an important part

- Some Pension funds have decided to use the expertise of their fund accountants as the full FTK process is complicated. The Fund Accountants are naturally best positioned to do this as they are in possession of the data

The current suggestions to the FCA for data collection are good, however this is not what is currently being collected elsewhere and will require enormous efforts to complete. From experience we understand the limitations of data collection, and we believe that we can leverage our experience in this domain to help the FCA replicate something similar to the Dutch model of cost collection, without excessive cost and effort.

Why do we feel that the Dutch model is a good starting point?

- There are well documented successes of FTK, and it is gaining momentum across Europe as the leading regulatory reporting framework. Rather than re-inventing the wheel, providers can transfer their expertise from other jurisdictions to limit the cost and complexity of having to comply
- There is opportunity for cross market comparison. By having a common data selection, there will be opportunity to contrast service providers and ensure that value for money is being evaluated by both DB and DC pension schemes
- The role of the *Fund Accountant–Custodian* cannot be underestimated in the process, as they are not only in possession of all the data, but are well skilled with interpreting it. Our experience in the Dutch market tells us that not only do Pension funds ask for advice on the best method of cost data collection, but also other key stakeholders, including asset managers, charities and investment funds.
- At KAS BANK we have a great deal of experience in helping stakeholders on the journey to providing correct cost information and understand where their challenges may lie

We are able to immediately provide the FCA and DWP with a summary of all cost categories in a simple template based on the Dutch model, where we are able to collect this data straight away. We believe that this approach will help make this transparent approach to cost collection a positive process for both regulators and the pension schemes.

We believe that in time the UK can play an influential role in influencing a European framework for standardised cost collection based upon the implementation of a practical and consistent method in this country. In the short term, we see that by utilising the example of FTK cost collection, a solution can be delivered quickly to provide both a stable foundation and the momentum to achieve greater transparency in the UK market.

Yours faithfully,

Sikko van Katwijk	Dr Christopher Sier
Managing Board	Managing Director UK
KAS BANK N.V.	KAS BANK N.V.

KAS BANK N.V.

Consultation Questions Response

Leveraging our experience of transparency initiatives in the Netherlands, we have answered a selection of questions where we feel our input could be beneficial. We would be more than happy to provide additional information upon request.

Question 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?

Disclosure of costs and charges can, and arguably should, be an industry-wide standard, and there are no reasons why standardised disclosures of transaction costs could not be applied to all schemes.

Question 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?

In principal transactions, costs are embedded within the trading spread; accordingly it is necessary to either record these at the time of transaction or to use model-derived proxies. It is possible to set standard estimates for use in cost evaluations, as was done by the Pensioen Federatie in the Netherlands. Breaking down a spread into quantifiable cost components is often difficult, which is why the Dutch estimation process is so appealing. Asset managers are given the opportunity to disclose segmented costs if they can/choose to, otherwise will have to comply with the agreed estimates, derived from the generic spreads of asset types. If standardised transaction costs or spreads are to be used, it is important that these are determined in consultation with the schemes to which they will be applied through a consensus approach with the regulator.

Question 3: What are the advantages and disadvantages of capturing and reporting market impact? Do you have any views on the ease of identifying market impact costs? What practical challenges are there in calculating market impact costs? Do you have any views on 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?

Market impact rules are important, to the extent that they are captured by best execution, however the rules do not capture the full extent of transaction efficiency. Currently there are no reliable estimates of the magnitude of market impact effects, though the use of algorithmic execution methods by institutional asset managers suggest that they may be substantial. To arrive at accurate estimates of the market impact there are a number of necessary precursor cost and fee disclosures that are necessary. Accordingly, due to the complexity of capture, we would suggest that market impact be left for attention at a later date should it appear that this becomes a material concern.

Question 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? If not, why not? 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?

We do believe that these types of costs are relevant and useful, however we do not feel they should be categorised as transaction costs. It is clear that norms and conditions for the measurement of these costs can be developed, however we would expect the measurement of these costs to be an integral part of the processes of good fund management. This is not an analysis into the costs directly borne by the members, but an interrogation into the quality of traders. The argument being that this burden of analysis should not be borne by members of the scheme, but by the asset managers who are appointed by them.

Question 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?

There are two distinct methods to approach the analysis of transaction costs. The first is a top down approach, which considers the performance of a portfolio relative to a counterfactual. The second is a bottom up approach, which considers individual transactions and turnover in a portfolio. The approach considered in the consultation paper and the illustrations cited are bottom up in nature. This is an approach taken in the Dutch FTK (Financial Assessment Framework), whereby the ranges of transaction costs have been estimated. A similar approach could work well in the UK, with the reserved agenda to also capture recordable 'booked' costs. This will allow us to provide an estimate to the market in the short term, increasing awareness of the costs that are charged, whilst building up a more detailed allocation in the background for future use. Significant modelling has been addressed in the Netherlands in an attempt to estimate the implicit transaction costs for OTC transactions. This could involve capturing actual broker spreads or estimating the average bid-offer spreads for certain asset subcategories.

The top down approach considers the gross and net performance of the portfolio relative to the counterfactual, which reflects the portfolio mandate terms and flexibilities. This type of approach is sometimes referred to as Random Portfolio Comparison. However, we believe that the bottom up approach will provide a better method as proven in the Netherlands.

Question 6: Do you have any comments about the different frameworks within which information might be reported and their respective strengths and weaknesses?

Current methods can be improved by expressing cost and fee data relative to income and returns, and not capital value.

The end objective should be to create something that resembles the Total Cost of Ownership model, rather than the current market practice which varies widely between AMC, TER, or bundled explicit costs. It must be stressed that the granular levels of data suggested is not impossible to obtain, in fact, quite the opposite. All information is held between the Custodian and Fund Manager, and should be independently valued by the Fund Accountant. Further government review should not be necessary, just a methodology of extracting this data from the existing systems, in a format that can be manipulated for the use of trustees and IGCs. In the Netherlands, the estimates that are completed for FTK reporting are calculated by the Custodian-Fund Accountant as they are in possession of the data and the output is solely decided by the end user. As the Custodian-Fund Accountant, KAS BANK knows how to compile the FTK reporting to the regulated standard and we know how to calculate the estimations used in the model, however at no point will we advise or offer an opinion on the information. The point being; that data should be collected and computed independently to facilitate the growing needs of Pension Scheme stakeholders over time, Once the regulator has provided pension schemes with the framework to have standardised reporting this then gives stakeholders a data set to utilise as they see fit.

Question 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?

There is certainly merit in trying to achieve the most detailed level of disclosures possible. All transaction cost are all relevant as they help build the picture of total costs incurred, however we realise that where some are clearly known and attainable, others are not. The Dutch model compensates for this by offering a booked cost approach where known, a model cost approach when not, or a combination of the two when a purely booked approach is not fully possible. This method is applied on a line by line basis throughout the entire portfolio to build a comprehensive look through into the costs that are incurred on every transaction. Over time, greater knowledge around booked costs will prevail and more accurate representations can be achieved, however in practice this is a well balance approach to greater insight in the short term.

Question 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?

There is significant scope for market distortion if the alternative strategies are not held to the same disclosure standards as traditional asset classes. We believe significant look-through is required if we are going to be able uphold transparency across the entire scheme, and this will involve some effort. Currently there is no look through information passed on from Fund of Fund vehicles and this provides significant limitations for comparability with more traditional asset classes where look through is more achievable. No separate guidelines should be needed for disclosures; however the responsibility to pass on information to parenting vehicles should be enforced. We recognise that alternative strategies will be held to a longer timescale for reporting to prevent any impact on their competitive advantage. There are some asset class specific fee arrangements which will need to be gathered and disclosed – for example, management advisory fees charge by the General Partner to investee companies in the case of private equity fund investments.

Question 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?

This is a complex area which should be the subject of a separate consultation after primary disclosure standards have been set. The Dutch model has realised the complex nature of these instruments, but has still appreciated the fact that they are an essential component of the overall transaction cost. As a result, they have maintained the process of applying basic levels of estimation at a transaction level to gauge the impact they are having on the overall portfolio, but are investigating means to develop the model further.

Question 10: Do 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?

Rather than a purely principles based approach we agree that a hybrid approach, as suggestions in the consultation document, is the best means to develop short term results, and a longer term framework for cost disclosure. Replicating a similar methodology to the standard estimation process suggested by FTK will at least give the means of generating awareness around the extent of transaction costs and fuel further discussion in the near future. Coupled with this will be the opportunity for asset managers to disclose specific cost data, the standards/definitions for which can be developed in response to the initial disclosures. This will set in motion the ability to quantify the estimates in time, and lead to achievable, natural regulation in the future. A benefit of the Dutch model is that the estimations used are generally considered to be overstated. This provides an incentive for asset managers to disclose the true costs which in turn give greater insight to actual charges that are being incurred.

Question 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?

Turnover is a fundamental metric to be recorded in regard to transaction costs as it directly quantifies the extent to which trading activity is having an effect on the cost/performance of a fund. We should clarify at this stage the difference between discretionary portfolio turnover that is driven by investment management decisions, and that which is responsive, caused by cash inflows/outflows, Dividend payments, etc. The best method to ensure comparability is one that allows for both these types.

Leveraging an existing industry calculation, for example the IMA Disclosure tables, would ensure consistency and comparability of the figure. This is something that is currently not addressed by FTK, but an area where the FCA can add significant value to the understanding of transaction costs.

Question 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?

Return information is a necessary reported disclosure because of its direct relation to costs through overall performance; however it is advised that reporting risk data is avoided as the relationship with risk is with returns rather than directly with costs. Not only will there be difficulties in communicating their calculation methodologies, but once again they fall under the category of investment decision making. The majority of stakeholders that this transparency agenda is helping do not have ready access to the tools and information that would allow them to do this directly and would put unnecessary onus on them to comply.. Risk metric reporting should stay under the remit of investment management; where as return information should be used in conjunction with cost data and distributed to

Question 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?

One of the clear current issues in fund management is the use of benchmarks as surrogate portfolio allocations, particularly with respect to risk based mandates. We prefer to think of benchmarks as counterfactuals which describe that which might have been done under a mandate's terms and flexibilities. We agree that there are many useful benefits that can result from benchmarking services, particularly assisting trustees/IGCs performing their requirement to assess value for money. However we must stress that benchmarking is a facility that is developed from a more transparent framework, rather than the reason for it. Sufficiently standardised and comparable data disclosure will offer satisfactory transparency, which will then give the option to explore benchmarking if they have further questions on their data. Benchmarking allows the data to be put into perspective, and will no doubt lead to enhanced understanding and further investigation from the affected stakeholders.

Question 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?

Activities such as FX trading and securities lending should be subject to full disclosure of all income and expense. It is important to understand how and where these activities are being used as they can often have a knock on effect elsewhere in the portfolio. For example, it is often difficult to gain information on how security lending is being used, but it is often thought to have a lowering effect on costs elsewhere, such as custody fees. Without clear disclosure it is hard to establish the impact elsewhere, and impossible to accurately compare costs. As with other principal transactions, spread estimates may be applied if there was not time of trading capture.

Question 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? How can the data be presented so it is of use to making ongoing decisions as well as a matter of historical record?

There should be a means of presenting data in a comparable and standardised format to the relevant stakeholders. There are already examples in the market that can offer this information to a varying degree of detail. We believe that the best means is by establishing a clear and uncomplicated base framework that also gives the trustees/IGCs the control to obtain greater look through if they choose. This approach will empower the end users, and allow them to perform the analysis necessary to satisfy themselves that value for money is being achieved.

Question 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?

Yes, the use of portfolio turnover rates and unit transaction costs do enable better prediction of likely transaction costs because we do not have access to the line by line transaction data in the UK, which they do in the Netherlands. Therefore turnover rates are a captive metric that provide a good estimate based on some knowledge of the underlying asset activity.

Question 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?

These regulations and rules should be broad and encompass the full range of situations where fiduciary responsibility applies. The regulatory guidelines should note this and ensure the onus is on providers to pension funds to provide the necessary data for them to comply.

Question 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?

When introducing any regulatory framework there will naturally be some cost involved, however we believe this will not be as high as assumed by some industry participants. If the industry can leverage experience of the application of FTK in the Netherlands, we can create a standard form that is easily implementable and relatively costless to do so. We do not suggest copying the FTK format in full, however there are significant advantages of utilising the annual cost reporting framework that can deliver benefits to the UK Pension industry. We see from the Dutch example that the transparency this framework provides has empowered pension schemes to have greater control over the costs that they bear. In the long run this can have a positive impact on scheme funding, thereby creating a sustainable future for UK pension funds.

Disclaimer:

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