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Assessments of Value for UK authorised investment funds – what's new?

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Assessments of Value for UK authorised investment funds – what's new?

Now UK authorised fund managers are in the second year of generating Assessment of Value Reports for their UK authorised investment funds, it is perhaps a good time to review interesting trends or themes emerging.

There are new comments from the FCA to address regarding fund managers falling short on assessing the value of their funds.

However the Assessment of Value process is likely engendering, in a particular way, a formalisation of what should have been going on in any event. It is perhaps important for this exercise now to be viewed in a wider context – as part of how Management Companies should conduct their activities in the best interests of investors. We would suggest that Management Companies should, going forwards, look to integrate their Assessment of Value processes into wider initiatives which, on an ongoing basis - not just on an annual assessment basis - should be evident in all of their product review processes and governance arrangements.

FCA comments

On 6 July, the FCA published their long awaited comments arising from their review of eighteen fund managers between July 2020 and May 2021.

The results are not encouraging. The FCA found that *"most had not implemented Assessments of Value (AoV) arrangements that met FCA standards."* The FCA commented: *"Overall, we expect more rigour from AFMs when assessing value in funds. This will help ensure that investment products represent good value."*

Some high level points arising will be surprising - at least to those who did comprehensive asset value processes and good reports. Comments in the "surprising" category include:

- firms failing to comply with requirement to assess value at the unit class rather than at just the fund level
- a failure when reviewing investment performance to look at where there is underperformance as against the markets in which they are invested – rather than simply looking for positive returns. Funds which generate positive returns do not necessarily deliver good value
- a failure to sense check outputs of review processes to ensure that conclusions make sense and reflect the AFM Board's overall view of a fund's value. This could arise from mechanical application of the assessment and waiting of the respective considerations under the seven pillars. There cannot be too much weighting on a fund's performance at the expense of looking at potential value concerns in other areas such as economies of scale or AFM costs and consideration of these at the AFM Board.

Other comments of interest though pick up on some new aspects of Assessment of Value reports which may not have been evident in the past, considering the way in which funds have been explained and details disclosed

about them to investors. Notably fund managers have started to talk about their style of investing in their Assessment of Value reports– and this indeed fits with the COLL 6.6.21R(2) requirement an AFM having regard to a fund's investment objectives, policy and strategy when considering performance over an appropriate timescale. The difficulty arises though if a firm attributes underperformance to the style of investing and yet that style of investing, and risks of relative underperformance for long time periods attached to it, have not otherwise been clearly disclosed to investors in KII documents or factsheets.

Clearly the FCA consider there is quite a lot of "work in progress" in the processes many firms adopt. They will be looking for improvements over the next twelve to eighteen months before they perform their next assessment of how well firms have reacted to this feedback. There is an indication that the FCA will consider other regulatory tools should they find that firms are not meeting the standards the FCA expects to be necessary to comply with its rules.

In the following sections of this Briefing Paper, we look at the various features which have been emerging from the initial attempts to value assessments and then the ongoing challenges in greater detail.

Features

To report a few particular features which are emerging from review of fund managers' first attempts at value assessments and give some comment on good and bad aspects of these:

- **Lack of prescription**

  Lack of prescription should be seen as a good thing!

  An Assessment of Value is supposed to be the AFM's own statement of its assessment of value. If we try to turn it into something more formulaic, along for example the lines of a KIID document, that individualism would be lost. Specific templates or requirements would force all fund managers to take the same approach but may not suit each of them. If the Investment Association were to produce some form of template or a more formalised guidance than their current Value Assessment Reports – Analysis and Initial Recommendations paper, the likelihood is that there would be a herding around a standard approach which could be to the detriment of the level of individual communication offered.

  If the FCA were to increase the level of prescription as to how Assessments of Value should be undertaken, whether by specifying pillars or by setting out in detail how to present an Assessment of Value Report, that would remove the flexibility for AFMs to report as they wish to do, and in a free form way of doing so. Turning it into a tick box exercise would be a regressive step.

- **Freedom to identify pillars**

  To date, it is the element of flexibility which permits fund managers to determine the pillars against which they report, so long as they report on the core seven pillars identified. It has been a feature so far that AFMs have stuck to those identified with very few exceptions.

  Essentially, interesting or individual issues which AFMs have identified in their internal assessment processes have been shoehorned into the existing pillars identified by the FCA rather than treated as new pillars.

  It will be interesting to see what new topics might be identified as separate pillars over time. Product governance could be one, as the need for value to be demonstrated in this area is so important. Some hot topics could also be considered – but perhaps these should be treated with more caution.

- **How to deal with hot topics such as ESG**

  There might be a temptation to look specifically at new areas of interest, and notably ESG happens to be the current hot topic where there is some eagerness to report activities in that area.

  ESG could have its own pillar but maybe covered within other pillars such as performance. Indeed it is premature to look at ESG at the moment for UK funds, given the lack of common metrics on which to assess performance in this area. For UK funds, the EU categorisation provisions do not apply and the UK is yet to develop our own.

It is too early to ascertain common metrics for assessing ESG matters for UK funds which are generally accepted and widely utilised and in some way "standard" so that any such reporting could be useful to readers and allow comparisons to other fund managers' funds.

- **Not an isolated exercise**

  Certainly in Year 1 there was a temptation to view the Assessment of Value as a completely new exercise to be conducted in isolation. Whilst the Year 1 projects did indeed need to be distinct projects, it is becoming increasingly clear that many of the issues which arise in the work required within a firm to generate the reports should be well integrated with "business as usual" activities and, on a wider regulatory approach, are integral to wider regulatory initiatives.

  An AFM Board should be conducting ongoing reviews of all products and it should equally be inevitable that numerous elements which arise for consideration in relation to Assessments of Value should in any event be considered as part of the ongoing work on both product governance and the investment team's review of investment performance, just to take two examples. Review of fee structures also should not need to be an issue arising from the annual Assessment of Value but should be an ongoing process of review of whether pricing of funds is appropriate and fit for purpose.

  We expect that, as firms try to streamline their new procedures for the internal review work to generate management information to assist in the Assessment of Value, much of this will be derived from the work undertaken on particular topics throughout the year.

- **A living document—to be updated**

  There has been a temptation to consider the Assessment of Value's annual exercise in respect of the relevant annual reporting period. Whilst this is not untrue, not only a firm's work behind the scenes in generating the management information required to generate one but also the output given in the statements which are published should be viewed as part of an ongoing exercise.

  We expect that, in each report, a firm will indicate improvements in value delivered in a particular year and indicates how it will seek to improve value delivered in the subsequent year. Consequently, in each following year of course there has to be a lookback to see if it has delivered on projects which it has in the previous year indicated should be ones which make a difference. Have they in fact improved the value delivered in the way they expected?

  In other words, a statement is a living document which will tell a story year on year.

  The more of course one indicates about plans in process for improving value in future years, the more difficult it is should those projects not reach fruition or not deliver extra value. But we would suggest that the aim should not just be to report on value delivered but how matters might also be improved. So this is a useful area to include.

As a result of these and other issues found within the wide range of approaches taken in the first year of generating Assessment of Value reports, we expect that the quality of reports produced will improve in the second year. Hopefully over time there will be a useful annual marker for the firms themselves – not just for the investors for whom they are designed – in making AFM Boards review their progress on delivering value to investors.

Challenges

Indisputably, there are still considerable challenges with the Assessment of Value exercise of these challenges. Some of these are not just to do with the assessment itself.

To give some colour to the challenges typically being discussed:

- **Assessing economies of scale**

  There are particular challenges in meeting FCA's expectations with regards to costs and economies of scale. In comments, the FCA have made it clear that they think the economies of scale point is to be assessed in a straightforward way as one would expect it to be for a manufacturing business. The problem is that authorised investment funds do not operate in that way and there is no easy way of organising management information as if they did so.

Assessments of Value for UK authorised investment funds – what's new?

Manufacturing UK authorised investment funds is not analogous to manufacturing widgets and also their production is not undertaken in isolation, particularly in larger asset management groups.

Ways in which authorised fund managers can try and assess economies of scale have to be looked at more holistically at the enterprise level. This introduces the challenge of how to try and allocate costs. Even the exercise of allocating costs to UK authorised funds (as opposed to other areas of business such as segregated mandates) should not be underestimated, and many managers are negotiating mandates with their supplier firms on a business basis which may likely involve several fund ranges, not just UK authorised funds but other UK funds and, for example, Luxembourg and Dublin funds.

Further, even if economies of scale were to be identified, then what to do with them would be another challenge. It might not necessarily be as simple as feeding them back through a cheaper price.

Nonetheless, there is a need to work out an appropriate way to model costs and to allocate them. In their July review comments, the FCA note that some firms have made "*very little progress in developing a methodology for measuring them to date. Where some firms have made progress and, in some cases, modelled fund costs in considerable detail, they typically could not demonstrate how this work was used in Board discussions. This is disappointing and we need firms to complete their work in this area.*" One particular point is that, even if a firm's modelling of costs looks detailed, it can rely too heavily on allocating costs based on fund size rather than the more precise analysis of the actual costs of operating the fund – and inevitably allocating by reference to assets under management does not indicate if there are benefits from economies of scale.

- **Meeting the FCA's expectations**

Whilst AFMs do of course need to produce the Assessments of Value, that does not mean to say that AFMs need necessarily agree with all aspects of the FCA's objectives which are behind their Assessment of Value initiative and particularly the focus on price.

There has been a long running debate in a number of contexts, be it for ISAs, pensions or funds, about whether price is something which on its own should merit attention. It is not necessarily the case that a cheap fund is a better fund. Some strategies are more costly to run than others. Active management is more expensive to provide than passive management.

Some managers may legitimately argue that the quality of the product they deliver, whether on an investment or service basis, justifies the particular fee they choose to levy. And indeed the logic in UK authorised funds has always been that they are open-ended funds and, if investors think they are too expensive, they could always redeem.

Further, there is a much more general point which is that it is not for the regulator to set price. The FCA have indeed confirmed this in the FCA's CP21/13 on a new Consumer Duty published on 14 May. It is perhaps useful to recite how they express their position:

"*Consequently, we want to set out a clear and consistent expectation of how firms should assess whether the price of products and services offers fair value. Firms should be able to demonstrate that the benefits of their products and services are reasonable relative to their price. We want firms to actively put consumers at the heart of their business and assess the price of products and services at the design stage, and through ongoing monitoring.*

We are not proposing to set the levels at which firms should price their products or services. Nor do we intend to use the proposed rule itself to introduce market interventions, such as price caps or other price interventions, as we have done for example in the rent to own and overdrafts markets. In future we may need to use our regulatory tools to make such interventions where markets are failing to deliver fair value. But the aim of our proposal is to require firms to give greater consideration to the price and the role it plays in relation to the fair value of products and services. This should reduce the need for us to make any such future market-wide inventions."

This helpfully clarifies the FCA's approach on a wider basis than simply for investment funds but one assumes equally applicable to such investment funds.

The task is therefore for AFM Boards to give greater consideration to the price issue and one assumes for Boards to be able to justify why, whatever the price is, it is considered to be fair and, overall, the role a price

plays in relation to the product means that overall fair value is delivered.

- **Demonstrating a good process**

  On each issue reviewed and for the Assessment of Value process generally, it is important to be able to demonstrate that a detailed and thorough process has been undertaken.

  The good AFMs have probably done really well at meeting the FCA's expectations on being able to demonstrate that they have undertaken a detailed and thorough process in creating their value assessments. It is clear though that the FCA think that some firms have further work to do.

  In the FCA's MiFID II product governance review issued on 26 February, there are some interesting comments on authorised fund manager (AFM) Boards. Within their review, key areas on which the FCA focussed were the second line of defence and product governance committees; the obligations of the authorised fund manager AFM Board; and how firms approach recordkeeping and training on product governance.

  Specifically in relation to AFM Boards, the FCA commented that:

  "While firms were aware of the AFM Board's product governance obligations and the need for oversight of the relevant committees' work or their second-line functions, there was variation in the quality of contribution from the independent Non-Executive Directors. We observed some instances of reasonable challenge, but not in all firms. For example, from our discussions we heard challenge being limited to areas where the independent Non-Executive Director has the greatest expertise, leading to a potential lack of proactive challenge in other areas."

  This demonstrates not only the need for the Assessment of Value exercise not to be conducted in isolation – a point mentioned above - but also the focus now on the strengths required of, and evidence of detailed work undertaken by, AFM Boards. For example, there should be:

  - a much wider concern that firms should demonstrate good governance in how AFM Boards operate;
  - a clear need to make sure that committee work is reported up to the AFM Board in a timely fashion so as to enable a challenge from the Board; and
  - ongoing proactive challenge on all aspects of product governance.

  All of this ongoing work should then obviously lead to the Board – including iNEDs - being well informed and fully appraised so it can perform the Assessment of Value on an annual basis by reference to all of that ongoing work.

  In the FCA's review published this month, the FCA observe that even when firms had good frameworks for the process, the FCA often saw a gap between the data being provided by the frameworks and the value conclusions reached by the AFM Boards which firms could not explain to the FCA. This area clearly needs careful consideration by AFM Boards going forward.

- **Record keeping**

  In order to demonstrate the process, good record keeping is obviously important.

  From a supervisory viewpoint, it is important that asset managers record how they have undertaking all this activity. As recorded in the FCA's comments on the MiFID II product governance review, the FCA's assertion is that:

  "Most asset managers had poor record keeping. This may have been due to a lack of formal process in product design and oversight. Critically, where firms did not document challenge, decisions and checks, they were unable to recall what activities had taken place.

  The inability to evidence robust challenge and oversight should raise concern for those individuals accountable for this activity (the focus of the new Senior Management and Certification Regime) as it leaves firms and those accountable unable to evidence challenge and oversight, potentially in breach of SYSC 9.1.1R."

  This comment reinforces the point made above: not only that matters cannot be looked at in isolation - as here, for example, is a link to Senior Managers' responsibilities - but also a need generally to improve the whole record keeping exercise in relation to an AFM Board's activities and the committees underlying such a Board.

Assessments of Value for UK authorised investment funds – what's new?

In the Investment Association's Analysis and Initial Recommendations regarding Value Assessment Approach published in April 2021, there is an indication on page 7 that *"At its core, the value assessment required is a governance requirement rather than a disclosure requirement."*

The focus is as much on the *process* of the AFM Boards in reaching a conclusion on the Assessment of Value as much of the information provided to investors and IFAs etc in reading the published Assessment of Value statements.

- **Role of the iNEDs**

Within the FCA's comments, the second reason for demonstrating the process is to enable iNEDs to undertake their activities as the FCA anticipate should be the case.

The FCA's comments on the MiFID II product governance review note the variation in the quality of contribution from independent non-executive directors. There are though wider issues to consider in relation to the degree to which iNEDs can influence AFM Boards effectively.

First, inevitably iNEDs are in the minority. They can only really encourage the executive team to work in a way which meets the FCA's expectations on product governance and assessing value.

Secondly, iNEDs can only be as good as the information they have available. Early sighting on activities within the business is important. Early and regular disclosure to iNEDs of information relating to the funds from underlying committees and on all aspects of the business on an ongoing basis is important, so that the iNEDs are in a position to provide effective challenge.

Some asset managers may consider appointing an independent Chair. This could be useful in setting agendas and ensuring timely disclosure of issues which are in the pipeline, without changing the voting dynamics and prejudicing the executive's ability to manage the business.

Looking specifically at the Assessment of Value exercise, looking at what could be improved in the Year 2 Reports, review early on in identifying key issues, perhaps on how delivery is to be improved in the future year, could be undertaken *prior* to the end of the relevant reporting period. Having workshops at an early stage while the executive team are developing issues involving the full Board and iNEDs can be helpful.

Also probably iNEDs key role is providing a fresh eye. That is always helpful: the executive can sometimes be too close to some issues to see the obvious.

In the same way as there is resistance to regulator interference on setting product prices, one suspects that AFMs will likely resist interference in an AFM Board's executive powers to manage the business. At the core, it is the fund manager's product board and it governs the fund manager's products, and so the manager should be able to determine the direction of travel for those products. We would therefore assert that the emphasis should be on enabling iNEDs to influence on a timely basis and demonstrate they have provided challenge to the executive, rather than anything more than that.

The question is how far the FCA really want to go in enforcing the level of engagement/influence which can be achieved by iNEDs within AFM Boards. Clearly, in their comments this month, the FCA are indicating that some of the independent directors on the Boards of AFMs did not provide the robust challenge that the FCA expected and appeared to lack sufficient understanding of relevant fund rules. As the FCA commented: *"We expect independent directors to ask the difficult questions we asked in this review: in practice we did not observe enough independent directors doing this."*

- **Benefits for the reader?**

Attention is clearly being given to delivery of reports which are in plain English and approachable by the reader.

Perhaps some of the lack of engagement from the investor community in reading value statements will change as the quality of reports improve, and also as the accessibility of those reports improve.

Some AFMs have made a really comprehensive first attempt with them being accessible on websites and individually, and findable on websites. For others though, they have been somewhat more hidden away and so perhaps the lack of investor pick up is not surprising. Certainly if it is not accessed, the impact

Assessments of Value for UK authorised investment funds – what's new?

on investors and advisers will be none. If they cannot find it, the answer will be none.

One disappointing aspect so far however has been the lack of investor and IFA pick up of the Assessments of Value as a useful tool.

Indeed if they are to be picked up, the risk is that sometimes the reader's reaction might be only if there is a negative issue and so poor value is reported: perhaps the likely response would be a redemption, but that might not be the right reaction! There could be poor value for a number of reasons but redemption may not be the right action.

There may simply be an issue which is market related or to do with a short term issue which will play out and the full context needs to be reviewed.

Further, some commentators have dismissed the likelihood of the investors really picking up the Assessments of Value in any meaningful way. They indicate the likelihood that other documents will be the ones on which investors focus – for example the KIIDs and past performance.

There are wider issues to consider in all materials published – and indeed issues regarding consistency as between Prospectuses, KIIDs, Assessments of Value and other public statements issued by fund managers. All are part of the process of engaging with investors – and this point again demonstrates that we should not view Assessment of Value in isolation.

Improvements to be made

It is important for firms to look at the FCA's review published this month and consider whether points the FCA make should lead the AFM to alter the way in which it conducts future Assessments of Value and, where necessary, implement appropriate changes.

It is likely the Assessments of Value will get better as fund managers embed the system for their generation year on year – and increasingly as part of an integrated approach to Assessment of Value and the wider product governance reviews, demonstrating sound governance practices which the FCA are clearly determined that fund managers must achieve.

We do at least now have the additional high level "signalling" from the FCA of what they would like to see. The FCA have made it clear that they expect to find firms complying fully with their rules when the next review occurs.

Hopefully, the FCA will retain the approach of setting only high level principles and not prescribing detail. We would assert that it is welcome that it is left to each fund manager to determine how best it delivers value; how best to assess whether it delivers value; and how best it reports this to its investors. This helps leave the important decisions still with the fund managers so that they are free to determine what products to offer and their price, and how they review products and justify their value to themselves, to investors and to the regulator.

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