The Financial Inclusion and Markets Centre

Promoting finance that works for the economy, environment, and society

FCA CONSULTATION

CP24/30 A NEW PRODUCT INFORMATION FRAMEWORK FOR CONSUMER COMPOSITE INVESTMENTS

SUBMISSION BY THE FINANCIAL INCLUSION AND MARKETS CENTRE

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Introduction

The Financial Inclusion and Markets Centre is a dedicated unit of the Financial Inclusion Centre which focuses on financial services policy and regulation, financial market reform, and evaluating the economic, environmental, and social utility of finance. The new unit also covers work evaluating the impact of developments at the intersection of finance and technology including AI.[1]

We are pleased to submit a response to such an important consultation. The scale of the challenge of transferring a very complex EU set of regimes into a more effective, relevant UK regime should not be underestimated. The FCA should be congratulated for the work that has gone into this initiative.

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Summary of our submission

Unfortunately, we do not have the resources to answer all the questions. So, we have focused on what we think are the most critical aspects: cost and charges, risk and reward, and past performance.

We support the overall structure of the FCA's proposed regime. But, we do have some concerns about how the FCA intends for past performance to be used. Past performance data must be decoupled from the effect of charges and past performance decoupled from future performance in investors' thinking.

We cannot use past performance to predict future performance whereas we can model the effects of high charges on fund values. Past performance should not be allowed to be used to create the impression that a firm or intermediary has superior investment skills which are likely to be repeated and so influence investor decisions. Nor should past performance data be allowed to create the impression that superior future performance can compensate for high charges and costs.

With regards to the other main issues, we make the following brief points. We do agree with the FCA's proposals on the scope of the CCI regime. This should be as permissive as possible in the sense that all products with the characteristics described in the CP should be presumed to be covered by the new regime.

We generally support the high level proposals for responsibility along the distribution chain. But, we are concerned about some of the proposals in relation to unauthorised manufacturers including overseas funds available through the OFR. There is no compelling evidence that enabling access to an even greater number of products in an already oversupplied market will promote real competition and enhance consumer outcomes.

[1] About | The Financial Inclusion Centre

Indeed, there is a case for saying that more choice creates additional confusion, adds to market complexity, increases search costs, and exposes investors to greater redress risk but with little or no enhancement to investor welfare to compensate.

The FCA does intend to apply basic governance standards to unauthorised manufacturers. But, we would welcome further scenario analysis of whether this would be robust enough to protect investors from the type of harm caused by firms and funds in the past that were not within (or fully within) the FCA's perimeter. Moreover, as the FCA acknowledges whether a manufacturer is authorised or not can affect access to redress. We are not convinced that disclosure, even if is well designed, will be enough to protect consumers from the risks associated with unauthorised manufacturers. Therefore, we think there is a case for requiring distributors who choose to distribute funds from unauthorised manufacturers to take on the full responsibility in the event of things going wrong.

As we have covered elsewhere, we are very concerned about the Advice Guidance Boundary Review (AGBR). We consider this to be a weakening of consumer protection as the boundary of responsibility and liability for poor outcomes is being moved away from the market to consumers.[2] Therefore, it is critical that the CCI regime ensures that claims about superior investment performance are not allowed to influence investor decisions.

We fully support the FCA's intention to streamline and remove unnecessary information. The preceding EU regimes are far too complicated. We also fully support the FCA's intention that this should be a digital first regime.

Response to specific questions

Costs and charges
Question 21: Do you agree with the costs and charges we are proposing to require the disclosure of? If not, please explain why and what alternative approaches you would suggest.

Question 22: Do you agree with our approach to disclosing transaction costs? If not, please explain why.

Question 23: Do you agree with adopting the PRIIPs methodology for calculating transaction costs? If not, please explain why and what alternative methodologies you would suggest.

Yes, we agree.

[2] FCA Advice/Guidance Boundary Review CP24/27 | The Financial Inclusion Centre

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Question 24: Do you agree with our approach to pulling through costs? If not, please explain why.

We are pleased that the FCA is deciding to require the inclusion of underlying cost information. It is important that the industry is required to disclose the existence and impact of all costs involved in asset management along the supply chain.

Question 25: Do you agree with our product specific cost disclosure requirements? If not, please explain why and if we should extend any of these more broadly. Are there any other product specific clarifications we should consider?

We were becoming increasingly concerned that the investment trust lobby was trying to conceal the true costs of investing via closed end investment companies by asserting that the costs were already accounted for in the share price. It is important that all the costs associated with investment decisions and management regardless of the specific investment vehicle are disclosed in a clear, standardised way to allow for meaningful comparisons.

There may well be a case for excluding costs incurred in the maintenance and commercial operation of real assets If these are genuine physical asset running costs rather investment costs. However, care needs to be taken that investment companies do not try to take advantage of this to reclassify investment costs and running costs.

We do not agree with the proposal on gearing costs. The decision to include gearing as a part of an investment strategy has cost implications so should be included. The risk associated with gearing should also be dealt with separately.

With regards to IBIPs, it is not clear how the FCA intends to practically ensure that costs should be calculated net of profit share arrangements and shown in forward looking cost disclosures. The future value of profit share arrangements cannot be guaranteed.

Question 26: Do you agree with our proposals for the presentation of costs and charges? If not, please explain why and what alternative approaches would you suggest?

Costs and charges matter. Future good investment performance cannot be guaranteed nor should be implied by past performance data. The effects of high costs and charges can be modelled and should be presented.

We agree that ongoing costs should be shown as a single figure. Importantly, *all* costs should be calculated as a single figure and the impact on the fund's returns should be shown in money terms and percentage terms. We are not clear why the FCA is suggesting a 12 month period. Surely, it would make sense to require a period which is a better reflection of the typical holding periods for different cohorts of investors.

It may make sense to not require performance fees as these are contingent. But, this makes it even more important that firms are not allowed to use marketing material suggesting that the level of investment performance which might give rise to performance fees is achievable. Any new regime has to make clear at every relevant opportunity that past performance is not a predictor of future performance.

To summarise, we argue that the FCA should mandate the use of standardised projected returns for underlying asset classes and standardised projected real returns for total portfolios (based on the current asset allocations) showing:

- the impact of costs and charges on those projected returns (the reduction in yield)
- the impact on projected fund values over relevant time periods
- the total costs and charges extracted annually and cumulatively
- a comparison against benchmarks such as passive funds

The critical point we reiterate several times is that past performance data must be decoupled from the effect of charges. Past performance should not be allowed to be used to create the impression that a firm or intermediary has superior investment skills which would compensate for high charges and so influence investor decisions.

Question 27: Do you agree with our proposed changes to MiFID costs and charges? If not, please explain why. Are there any broader comments you would like to make on cost disclosure requirements under MiFID II?

Yes. But we would emphasise the importance of the FCA ensuring that any final disclosure regime is consistent across all types of investment vehicle regardless of the corporate or legal structure. This consistency needs to apply along the entire product supply chain from the end-user all the way through to the underlying real economy assets. All costs and charges related to investment management activity that reduce the return generated from the underlying assets should be accounted for.

Risk and reward
Question 28: Do you agree that we should maintain a standardised horizontal risk score for CCIs? If not, please explain why.

Yes, we agree with maintaining a standardised horizontal risk score for CCJs. It is important that any score based on volatility should accommodate the liquidity risks associated with 'alternative' investments, see below.

With regards to credit risk and capital guarantees, whether or not a risk score can be reduced should depend on the nature of the guarantee. Guarantees that depend on synthetic techniques are not guarantees, they are ambitions. These should be treated differently to guarantees based on actual cash guarantees.

And, of course, if firms are claiming that they are reducing the risk associated with a particular investment strategy using risk management techniques then they should also be required to reduce the projected returns from the product or any claims about future performance.

Investment theory holds that there is a positive relationship between risk and reward over the longer term – that is, if investors are willing to take a higher risk, they should expect to receive a better return. It follows that if the risk is supposed to be reduced, then the return expectations should also be reduced. Firms should not be allowed to create the impression of a win-win situation – lower risk with better returns.

Question 29: Do you agree with our proposals for narrative risk and reward requirements? If not, please explain why.

The critical point is that, while there is reason to think that there is a positive relationship in principle between risk and return over the long term, the risk/return premium is not always significant over the shorter periods which may better reflect the holding behaviours of ordinary investors. And high costs and charges can further reduce this risk/return premium.

We understand the pressure the FCA is under to 'nudge' investors into assets with potentially better risk adjusted returns. But, it is important that the FCA does not encourage overclaiming by the market of the risk/reward relationship.

Moreover, as mentioned above, past outperformance of specific asset managers/products is not a predictor of future performance. It is important that firms and intermediaries are not allowed to use past good performance (which was not predictable at the outset and cannot be guaranteed to be repeated) to override investors' concerns about risks.

The assessment of future risks must be decoupled from past performance to avoid investors being misled. This is why the FCA should mandate consistent projected returns to be used across the market.

It should not be forgotten that the FCA is considering weakening consumer protection through the Advice Guidance Boundary Review (AGBR). The AGBR as presented would result in moving the boundary of responsibility and liability for poor outcomes away from firms to consumers. The combination of the reduction in consumer protection and allowing firms and intermediaries to overstate the risk/return relationship creates obvious risks.

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Question 30: Do you agree that the starting basis for this risk score should be the standard deviation of volatility of the product's historical performance or proxy over the past 5 years? If not, please explain why.

Five years seems appropriate for calculating the standard deviation of volatility. However, we would welcome further analysis of whether five years is the appropriate time frame particularly whether this aligns well with investors' actual holding patterns.

Any calculation of the volatility of alternative investments should be done on the basis of what the investor would receive if they cashed in those investments at different points in time. Performance metrics such as IRRs can downplay the volatility of underlying assets and can present a false picture of the point-in-time real world performance of funds. Similarly, the calculation of the volatility of underlying assets/products that include penalty/transfer charges for early redemption should also incorporate that.

Question 31: Do you agree that we should expand the risk metric from 1-7 to 1-10 to differentiate a larger range of products? If not, please explain why.

In principle, yes we agree that expanding the risk metric range should allow for better representation of risks. However, we look forward to seeing the further consumer research before reaching a conclusion on the best approach.

Question 32: Do you agree that firms should consider amending the risk class where they deem it does not accurately reflect the risk of product specifics? If not, please explain why.

We are unclear as to why the FCA says 'should consider amending'. Surely, if the risk class does not accurately reflect the risk, they should be required to amend the risk class.

Question 33: Do you agree with the proposals for products within the high-risk category? If not, please explain why.

We think the FCA has captured the main high risk products. This high risk list would need to be kept updated to accommodate market conditions and market 'innovations'. It is not clear how the FCA would manage this. We would welcome more detail on how the FCA would categorise new types of products or re-categorise existing products going forward and require firms to respond accordingly. It would not be appropriate to allow firms to determine categorisation of new products or re-categorisation of existing products.

Question 34: Do you agree with the proposals for how to apply the risk score to different types of structured products? If not, please explain why.

In the main, yes. For capital guaranteed notes we agree the manufacturer should determine the risk score initially on the basis of the underlying asset class, or mix of asset classes, and

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adjust for specific risks. The FCA should make it clear that any adjustment to the risk should incorporate an upward revision of the risk if the product has any penalties which would mean that the investor would get back less than the value of the underlying assets if cashing in the product before maturity.

For structured deposits, where the initial capital is subject to the same protections as a bank account, the FCA does not specify what ‘same protections’ means. If this means the investor is protected from capital volatility as would be the case with a bank deposit account then we would agree the starting point should be a risk rating of 1. If not, then the rating should be higher. If capital is promoted as being ‘guaranteed’, the risk rating should depend on how any guarantee is delivered. Guarantees that depend on synthetic techniques such as derivatives are not guarantees, they are ambitions. These should be treated differently to guarantees based on actual cash guarantees where investor assets are held on deposit.

We agree that structured capital-at-risk products should be given at least a risk rating of 9. We are concerned that the FCA would consider it appropriate for manufacturers or distributors of structured products to provide alternative, industry standard measures of risk, such as Value-at-Risk. This risks add to complexity and undermining the FCA’s efforts to explain risk and reward more effectively.

For IBIPs the calculation of the overall volatility for the product after the selection of the underlying components should be the most appropriate for presentation to investors. Volatility of individual underlying assets should be disclosed elsewhere to allow external assessment of the true nature of risk inherent in insurance based products. We are concerned about the FCA’s comments about the benefits of diversification. The benefits of diversification can be overstated as during moments of crisis the correlation of assets tends to rise towards 1. So, it is important for the FCA to prevent insurers from overstating the supposed benefits of diversification.

For with-profits policies, we agree the volatility should be calculated based on the underlying investment. However, if smoothing is to be included this should be adjusted for any penalties applied for cashing in a policy before maturity.

Past performance

Question 35: Do you agree with our proposals to require showing past performance? If not, please explain why.

We agree that firms (and intermediaries/distributors) should be required to show past performance in the appropriate context. The context matters. We differentiate between the use of past performance for marketing and sales purposes and for reporting and accountability purposes.

As mentioned above, past performance data must be decoupled from the effect of charges and past performance decoupled from future performance in investors' thinking. We cannot use past performance to predict future performance whereas we can model the effects of high charges on fund values.

Past performance should not be allowed to be used to create the impression that a firm or intermediary has superior investment skills which are likely to be repeated and so influence investor decisions. Nor should past performance data be allowed to create the impression that superior future performance can compensate for high charges and costs.

So, we would argue that past performance data should not be used during the marketing and selling of products to new customers (or marketing and selling of new products to existing customers) *unless* the fund has underperformed its benchmarks, in which case this should be disclosed to the investor. A firm or intermediary/distributor recommending such a fund should be required to explain clearly why this fund is being recommended.

This may seem draconian but it is very important that the FCA decouples past performance and future performance and performance and charges. We are very concerned that recently the wider Value for Money (VFM) agenda is starting to divert attention away from the importance of charges and is placing too much emphasis on role of investment performance measured on a net-of-costs basis.

Of course, once an investor has invested in a fund the past performance against relevant benchmarks should be reported to enable accountability and to require investment managers and intermediaries to justify selling and recommending of high cost investment vehicles when lower cost alternatives such as passive funds are available.

Firms should be required to publish on their websites past performance data of all funds measured against the appropriate benchmarks with a summary of the performance of a firm's stable of funds. To allow for tailoring to specific investor needs, firms should allow investors to compare funds over a default period and specify periods over which performance is compared. The default comparison period would be ten years to the most recent date. Investors should also be able to specify their own start period eg. when they first invested in the fund.

Firms and intermediaries/distributors should be required to disclose to investors where a firm is performing poorly across the stable of funds.

With regards to structured products, we are unclear as to why the FCA says that past performance is not available. Firms could show what would have happened if the investor had sold the product at specific points from when they purchased the product to the current date.

We agree with the proposal for with-profits funds to show the effect of market value reductions.

Closed end investment companies should be required to include both share price and net asset value performance. This would be a helpful further illustration of the risks associated with closed end investment companies.

Question 36: Do you agree with our proposed requirements for a line graph for products that have past performance? If not, please explain why.

Yes, we agree there should be a line graph for products that have past performance. But, to reiterate this should be used for reporting and accountability purposes not for marketing purposes.

Question 37: Do you agree with our proposal to require up to 10 calendar years of past performance data to be shown where data is available? If not, please explain why.

Yes, we agree with the FCA's proposal on 10 years. But, we are unclear why this should be calendar years. With interactive technologies, investors should be able to see performance of a default period of ten years to the current date and specify their own dates.

Question 38: Do you agree with our proposed requirements for the inclusion of benchmarks in the line graph? If not, please explain why.

Yes. We very much agree that benchmarks should be included in comparative performance charts to aid accountability. There should be two benchmarks. A benchmark risk-free product (cash or cash/gilts) and relevant passive funds average (or benchmark index adjusted for typical passive fund charges). For mixed assets funds, there are two options. With the first, the current asset allocation of the fund could be used along with the relevant passive fund average performance in the different asset classes (or benchmark index adjusted for typical passive fund charges). With the second option, an external composite benchmark asset allocation could be used with the relevant passive fund average performance in the different asset classes.

Question 39: Do you agree with our proposals for required basic information that must be disclosed? If not, please explain why.

Question 40: Is there any other basic information you think should be communicated to consumers?

We agree with the proposals for the required basic information.

We are concerned about the lack of transparency on the amount of climate damaging activities being financed by UK regulated firms, funds, and products. The FCA's sustainable investment label regime does not provide any real degree of transparency on which firms, funds, and products contain the highest proportion of climate harming investments. If we are to get to a position where we can hold UK financial sector and financial institutions for the degree of climate harm financed, we will need a mechanism to measure the 'greenness' or 'brownness' of the assets held within portfolios.[3] We would urge the FCA to take this opportunity to begin developing such a mechanism.

Question 41: Do you agree with our Cost Benefit Analysis? If not, please explain why.

We do think it is a very well structured framework. Unfortunately, we do not have the resources to evaluate the detail of the Cost Benefit Analysis. However, as mentioned above, we are concerned about the use of past performance data. If the FCA allows this to be used for marketing and sales purposes in a way that distracts from the importance of costs, we are concerned this could undermine consumer wellbeing.

This marks the end of our submission
March 2025

[3] See for example ESMA's Portfolio Greenness Ratio [ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds]

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