

Charges Disclosure

1. We have written this note to offer a summary analysis of the strengths and weaknesses of TER and some other charge disclosure approaches.
2. Over the last few years the FSA has undertaken consumer research and analysis work to explore the impact of different approaches to charges disclosure.
3. Our aim has been to explore how to ensure investors receive the information they need to understand the overall nature and impact of charges, whilst also helping them compare between substitutable products. We have considered approaches which draw together all of the charges an investor faces, including both product and fund charges, into a single message or linked messages.
4. Our analysis suggests a lack of transparency regarding charges can have widespread effects.
5. It can reduce competitive pressures, as it becomes harder for investors or advisers to compare between otherwise substitutable products which possess different charging structures. This can in turn lead to providers devising more and more complicated charging structures.
6. It can also impact on an investor or adviser's ability to grasp the overall nature of the charges for a particular product, making it harder to judge product suitability.

TER

7. TER is an historical measure, showing the ratio between a fund's actual charges and NAV. It does not include other charges which the investor might face.
8. It provides a single measure of ongoing fund charges which allows comparisons between funds. This can be of particular use when considering switching funds or choosing between funds, where it provides a basis for comparing the relative costs of different fund choices.
9. For some products these may be the only significant costs the investors face. For others, there could well be other charges which need to be considered.

Issues with TER

10. Despite its name, TER does not provide a 'total' view of charges. As noted, it excludes important charges at the product level, such as initial or exit charges.
11. Given this, TER is not a comprehensive measure of charges, and could be misleading for investors if positioned as such.
 - For instance, two products may possess very different overall charging structures, say with one possessing upfront charges and the other not, yet possess exactly the same TER. (See the *Example* below). This difference in charging structures could have a significant impact on returns to consumers which would not be apparent from the TER.

FSA Note outlining some thoughts on charges disclosure

29.06.06

- Providers could potentially take advantage of a focus on a measure such as TER which only provides part of the picture, by devising products which look competitive on a TER basis, but which have other charges which make them less competitive than they seem.

12. While one approach to charges disclosure might be to break it down into its logical constituent elements, our research suggests that doing this makes it difficult for investors to interpret the overall impact of charges.

- Research shows that many consumers find it difficult combining a number of different charges expressed in different ways to establish a view of the total cost of a product. In some cases this can be difficult for even the most numerate investors.
- For instance, for umbrella products this could mean the investor has to try and weigh-up the impact of a number of different fund charges according to the proportions invested while also trying to judge the effect of initial or other charges.
- This can make it difficult for investors to compare the overall proposition presented by otherwise substitutable products.
- The effect of the shape of a charging structure can be counter-intuitive for investors. For instance, the timing of charges can matter, with initial charges taken from premiums or contributions in some cases having a greater impact on overall returns than exist or surrender charges. This can all depend on whether charges are expressed in absolute or relative terms, and whether a product is a regular savings product or the investor makes a single lump sum investment.
- Also, the way in which information is disclosed can be important: some of our research suggests that many consumers find percentages difficult to understand, and that they respond better to information in the form of monetary values ('how much will charges affect what I might get back?')

13. Finally, by using historic figures TER can also be misleading, since the past is not necessarily the best guide to future charges and expenses.

- For instance, for new products charges and expenses may be higher at the beginning whilst fixed start-up costs are born by a potentially smaller pool of investors, but may be reasonably expected to fall over time. (The opposite scenario can occur with closed funds, where the lack of new money can cause charges and expenses to become more burdensome on remaining investors as investors withdraw).

Other tools

14. Charges disclosures can be devised which include all relevant product and fund charges within a single figure or set of figures. So as to properly balance the impact different charges might have on an investment, the approach needs to be sensitive to the timing of charges, since initial and final charges can have different effects. One way of doing this is to make some standardised and reasonable assumptions, for instance about future growth, so as to provide a basis against which the effect of charges can be illustrated.

FSA Note outlining some thoughts on charges disclosure
29.06.06

15. The monetary effect of charges can be shown using a table which illustrates the impact of charges should you withdraw from a product at different yearly intervals, up to the end of the contract or some default term, say ten years. Our research suggests that consumers process information in tabular format relatively well, and that they prefer seeing information in monetary terms.

- The *Example* below illustrates some key elements that could be shown by through such a table.
- Monetary figures for representative short and longer contract terms can also be used to aid consumers in comparing the charges between different products.

16. All the charges the investor might face can also be encapsulated and summarised by a single comprehensive figure, which makes comparisons between substitutable products possible, irrespective of the size of investments.

- Evidence from the UK market for life products suggests that when the FSA introduced a single charges measure like this – a figure showing the ‘reduction in yield’ for an investment due to charges – this had a positive effect on competition, and led to a reduction in the absolute level and complexity of charging structures.

Example

17. Below we show how charges might appear under TER compared to more comprehensive measures which include all charges. The figures first illustrate the product with an initial investment charge, and then illustrate it without.

18. Whilst a consumer might reasonably expect that the TER might include all of the expenses to be charged to the investment, this is not the case and the introduction of an initial charge has no impact on the TER that is disclosed.

19. However, the more comprehensive measure changes because of the initial charge.

Assuming an investment of £1,000 lump sum with a 5% initial charge, annual management charge of 0.75% and other expenses of 0.06%. Assuming a growth of 6% a year with Accumulation Units.

TER **0.81%**

More comprehensive measure **1.4%**

Effect of Charges table, showing monetary figures:

<i>At the end of year</i>	<i>Investment to date£</i>	<i>Effect of deductions to date £</i>	<i>What you might get back £</i>
1 Lump sum	1,000	61.10	1,000.00
3 Lump sum	1,000	86.60	1,100.00
5 Lump sum	1,000	118.00	1,220.00
10 Lump sum	1,000	221.00	1,570.00

FSA Note outlining some thoughts on charges disclosure

29.06.06

Compare this with the same investment made in a product which is otherwise identical but has *no* initial charge.

TER **0.81%** [The same as before]

More comprehensive measure **0.9%** [Lower than before]

Effect of Charges table, showing monetary figures:

<i>At the end of year</i>	<i>Investment to date£</i>	<i>Effect of deductions to date £</i>	<i>What you might get back £</i>
1 Lump sum	1,000	8.55	1,050
3 Lump sum	1,000	28.60	1,160
5 Lump sum	1,000	139.00	1,650.00
10 Lump sum	1,000	139.00	1,650.00

Calculation methods for different approaches

TER

20. TER is the simple ratio between the scheme's **total operating costs** and its **average net assets**, looking back over the last year.

21. The expenses are gross of tax, and the average net assets are derived from the NAV for the scheme without taking account of tax relief.

More Comprehensive Measure

22. The more comprehensive measure in the above example was calculated as follows:

- (a) the investment was accumulated on an assumed 6% growth rate, to a default term of ten years, with the charges and expenses deducted as and when they would apply. This gives a measure in monetary terms of the impact of charges over the ten years.
- (b) calculate the rate of return which would give you the same monetary amount as (a) but making no allowance for charges or expenses.
- Subtracting (b) from (a) gives the reduction in growth due to the effect of charges.

[For instance: in the first example, the calculation (a) gives £1570; solving for the growth needed to accrue £1570 gives you 4.6%, which is a reduction of 1.4%].