Mercer

welcome to brighter

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David Terris
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Dear Mr Terris,

Subject: Mercer response to the CFA Institute's "Exposure draft - Guidance statement on composites for fiduciary management providers to UK pension schemes"

The draft guidance statement covers various points with a special focus on the treatment of client-imposed restrictions for classifying clients into constrained and unconstrained composites.

After carefully reviewing the guidance statement and participating in the discussion during the related call organised by the Fiduciary Management Providers Technical Committee ("the Committee") of the CFA Institute on August 22, 2023, we provide the below comments in response.

Treatment of Client-Imposed Restrictions for Classifying Clients into Constrained and Unconstrained Composites

Until now, we have classified clients into the restricted composites whenever they imposed restrictions on us (whether related to hedge constraints, asset restrictions, or both, as applicable). Our interpretation of the existing guidance was founded on an intention of minimising subjectivity in client classification within composites.

However, we recognise that the Committee is seeking to clarify that there should be a materiality threshold when determining whether the solution offered to a client is constrained. Further that, broadly speaking, Fiduciary Managers ("FMs") should err on the side of deeming a scheme unconstrained when determining materiality. We acknowledge there may be benefits of such an approach - such as more deeply populated composites - but also note that it may result in other potentially less desirable effects, including unintended inconsistencies due to varying definitions of materiality across FMs, and increased dispersion in the ex-post performance of clients within the same composite.

We will support the committees request to move to a materiality-based approach for classifying clients between constrained and unconstrained composites in accordance with the draft guidance but note some of the less desirable impacts will likely transpire. We understand that the committee is not providing guidance on materiality thresholds, but we would welcome this.

Definition of the Liability Benchmark

The existing guidance specifies that client-relative returns used in composite performance reports should be calculated in relation to the 'Benchmark,' which should represent the full liability cash flows. To address potential ambiguity arising when clients provide benchmarks representing only the hedged liabilities, the new guidance places greater emphasis on the use of full liability cash flows (rather than hedge ratio-scaled values) as the benchmark for relative returns. We welcome this added clarity and note it appeared to be “new news” to some participants. We would expect if the guidance had been misinterpreted previously that such composites should be updated and re-issued.

Retrospective Application of Changes by FMs

We endorse the voluntary application of these changes on a retrospective basis. However, in cases where a FM reported returns relative to a scaled liability benchmark in the past (as opposed to relative to full liabilities), we believe that a retrospective restatement of returns should be made mandatory to maintain consistency across different FMs’ past performance within a given composite.

Yours sincerely

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