INVESTMENT CONSULTANTS MARKET INVESTIGATION

Summary of hearing with BBS Consultants and Actuaries Ltd (BBS) held on 7 November 2017

Introduction and description of services

1. BBS explained that it offers clients an investment consultancy service. It also offers actuarial consultancy services and administration services to their clients. Clients are predominantly Defined Benefits (DB) pension schemes (approximately 85% of BBS's revenue is derived from DB pension schemes and 15% from Defined Contribution (DC) pension schemes).

2. BBS have approximately 200 clients and focus on small to medium size pension funds, those with assets under management of up to about £200m.

3. BBS was able to compete with the bigger Investment Consultants based on their quality of service and reputation. In terms of its growth, this has been organic by acquiring new clients across a range of services and by offering additional services to existing clients.

4. There was a close relationship between the actuarial side and the investment consultancy side. For example, in the relation to funding and how they set up investment strategy and how they help mitigate the risk trustees face. BBS provided both actuarial and investment consultancy advice for some of its clients, but they also just provided investment advice – in those cases they work closely with the external actuary. However, BBS stated that when they do provide the two in combination, there were efficiencies in terms of the calculations and holistic and combined approach they undertake.

5. In terms of the strategic advice, the role of the advisor was to help the trustees determine what they wanted to achieve. This is typically affected by a limited number of factors, in particular risk appetite, employer covenant strength, funding plan and maturity of the scheme. A key consideration is how the investment strategy should evolve over time as the funding position changes in order to help the scheme meet its ultimate objectives, e.g. buy-out.

6. These factors influenced the approach to asset allocation. Different risk models were used to identify suitable asset allocations and a range of

example scenarios would be presented to clients. Hedging decisions are linked with both the initial strategy advice and initial asset allocation. Once asset classes have been agreed, BBS would then assist schemes in determining which managers to select.

7. BBS selected suitable managers by providing a short-list or direct recommendation of managers for different asset classes, interviewing managers/selecting, implementing the fund change and monitoring this, typically on a quarterly basis. BBS had an ongoing dialogue with its clients but the three-year review point is a natural trigger point. Clients make decisions on which manager to select based on the recommendations BBS gives, but different clients may choose differently depending on their beliefs or 'psychology' and on their appetite for complexity. Increasingly, BBS were providing direct advice on the specific manager/fund structure to be used.

8. BBS provided advice to both DB and DC schemes. On DC trust-based schemes they provided advice primarily on the selection of the default approach (for example, to ensure its assets are growing at a respectable rate and that there is an appropriate means to have risk reduced as members near retirement). They also advise on self-select options appropriate for specific schemes. Such self-select options will vary somewhat across clients depending on what would suit their members best. They provided similar advice to that given to DB clients, although due to the constraints inherent in DC, it is more formulaic than the tailored advice given in DB, but on DC contract schemes no advice on provider selection was generally given.

Number and frequency of Investment Consultancy tenders

9. BBS stated that they were currently invited to tender for one to two mandates a month for new clients. The cost of preparing a bid does not impact their decision to bid and BBS seldom turned down opportunities to bid. BBS are not often invited to tender for larger mandates for investment services as these typically require a level of sophistication that they did not currently possess. However, BBS believe that larger clients do not necessarily need a more sophisticated and complex solution in order to deal with the principal issues that pension schemes face.

10. When approaching a client, BBS will seek to understand the client's objectives, and define what they are trying to achieve, particularly their risk appetite.

11. When tendering, BBS was seeking to demonstrate to clients that they would do a good job: providing clients with credible proposed solutions. In terms of what 'good' looks like, BBS noted that there is no simple easy metric, they

sought to demonstrate that they understood the clients risk exposure and how to better manage these risks. The key measures of success used by BBS are whether the funding position of the scheme has improved and if risks are being controlled in line with expectations. Understanding the client's approach to risk was a key factor in determining the approach managing risk relative to the liabilities and the volatility in funding that could be tolerated as part of the journey to a fully funded position.

12. BBS reported on performance to clients on a quarterly basis and attended a trustee meeting at least once a year to discuss and review progress, which is focused on whether the overall strategy is achieving the objectives. Clients would also consider whether the performance of the assets (whether good or bad) was as a result of the performance of the asset classes itself, or because of the performance of individual managers. There would also be some benchmarking of specific types of funds against peer groups.

13. Existing clients would review BBS's performance on an annual basis, which could lead the client to put the mandate out to tender. Typically, this review could take the form of either:

(a) A partial review, which could be simply the client fee testing BBS, or

(b) A full review, which could result in a full tender of the mandate.

14. New contracts tend to be for a for a three to five year timeframe. BBS stated that they had a duty to remind clients that they should regularly review their performance. BBS do not often lose ongoing clients. When this had occurred, it might be as the result of a disagreement over how the strategy might evolve, and the level of risk it is appropriate for a group of trustees to take.

15. BBS's growth was predominantly from the acquisition of new clients across the full range of their services. New services from existing clients typically accounts for around [✂]. BBS was not aware of any 'lock-in' clauses acting as an impediment to switching consultants.

Demand Side

16. BBS stated that, over the last ten years, the quality of trustee boards had improved and sponsors also have a higher level of engagement. Where schemes had poorly managed boards, [✂].

17. Professional trustees were being increasingly used on Boards. Professional trustees are experienced business people who have knowledge and experience in this arena. Hence, they were more likely to challenge and engage in the advice given by consultants to trustees. BBS's experience was

that many professional trustees were previously employed by larger consultancies and therefore might have some bias towards the big three firms. However, BBS also observed that independent trustees who have used their services are satisfied with BBS and used them for other schemes.

18. In relation to the transparency in fees, BBS considered the main issue was with the fees for fiduciary management, as there were many examples where it was unclear as to what was being charged. For example, fiduciary management fees and asset management fees can be bundled together making it difficult for the client to understand what they were paying for. Reviews of fiduciary managers are often carried out by third-party oversight firms which can help to unwrap the fees

19. Reporting on the performance of a consultant or fiduciary manager in terms of potential remedies would be challenging, as it would be difficult to identify general benchmarks against which performance can be measured. In many cases, performance needs to be assessed on a scheme specific basis.

Conflicts of interest

20. BBS considered there was a potential conflict of interest if the advisor was recommending the client to invest in their own product, for example in relation to fiduciary management. BBS pointed out that firms that offered fiduciary management services had often build up their business and its infrastructure from the movement of existing advisory clients into a fiduciary mandate without a competitive tendering process (although the degree of new business competition had subsequently improved). Once moved into those arrangements, there was a perception that it is very difficult to reverse the decision.

21. BBS have carried out oversight work on fiduciary managers. A large part of this role was simply to explain the nature of the fiduciary arrangements in place and look to benchmark the provider against a market proxy and, also, against direct investment strategies.

22. There was evidence of investment consultants acting as fiduciary managers recommending funds which they have a stake in to their clients. There is a similar issue in relation to traditional asset managers who used their own in-house funds, however they do not have the same statutory advisory status as a fiduciary manager.

23. In relation to investment consultants that did not offer fiduciary management, BBS considered that they can however replicate the outcomes from fiduciary management but for a lower cost and without the same conflicts of interest.

24. On potential remedies, the simplest solution would be to separate fiduciary management from advisory functions. There would be a risk with the other alternative remedies that advisors would still not be properly independent.

25. BBS provided clients with advice on how master trusts operate as an option for them to consider but did not recommend the use of their own master trust. The exception was where there were relatively small amounts in DC schemes which it would not be cost effective to move and in these cases BBS offered them access to their own small master trust. The revenue from their master trust was very small and BBS would rather not have to use this route at all. In principle, BBS could see that there was the potential for conflict here if advisors were giving employers advice and offering their own master trust. Similarly, for fiduciary management, it would be preferable if there were a clean separation between advice and the products being advised on.

26. In relation to gifts and hospitality, BBS had a policy that they will not accept any gifts or hospitality beyond minimum levels (e.g. reasonable business lunches or seminar attendance) and therefore would support a full ban.

Barriers to entry and expansion

27. BBS considered that the most significant barrier to entry was availability of resources and the set-up costs required to enable a new business to service clients. Significant resources are required to research products, but it is possible to focus their research on what is most useful to clients rather than trying to cover the entire market. For larger clients, more resources are needed to match their requirements for a sophisticated approach.

28. BBS did not believe there would be a fundamental impact on their business if the FCA were to regulate investment consultancy, but it would not necessarily add any value in terms of quality of advice.