INVESTMENT CONSULTANTS MARKET INVESTIGATION

Summary of hearing with Mercer Limited (Mercer) held on 22 November 2017

Demand side

1. Mercer saw acting in the best interests of its clients as fundamental to its business. Mercer told the CMA that the majority of UK Defined Benefit (DB) pension schemes will soon be paying out more in pension payments each month than they receive in contributions. In addition, many of these pension schemes have sizeable deficits so a key aim of investment consulting is to help manage that risk, avoiding negative consequences for both the scheme sponsor and, as importantly, the underlying members.

2. The industry had developed sophisticated risk management and risk transfer techniques to assist plan sponsors and trustees as they work toward securing benefits for scheme members and limiting potential adverse impacts.

3. Fiduciary management has been one of the responses to managing these risks. It was a means for schemes to access a range of solutions and to do it quickly, cheaply and more easily than they could do themselves. Mercer is able to show the value added through fiduciary management in various ways, including that funding levels for Mercer's fiduciary management clients have improved [✄] faster than for DB pension schemes as a whole.

4. The assets in Defined Contribution (DC) pension schemes are growing rapidly and will accelerate as auto enrolment continues. Risk management is also key to DC schemes.

5. The investment consultancy market had changed considerably over the previous ten years and will continue to evolve. [✄]. The market is competitive with a wide range of participants pursuing different business models.

6. Strategic asset allocation was a key driver of pension scheme outcomes. Mercer has significant intellectual property in this area which it delivers to clients in various ways.

7. Mercer had added value of [✂] through its selection of ‘A-rated’ managers across the main asset classes. Mercer has had difficulty in reconciling the FCA’s work in this area (which concluded there was no value-add in manager selection across the main investment consultants) with its own analysis.

8. Mercer worked to drive down fees in asset management, particularly through its fiduciary management offerings. The majority of advisory clients negotiate fees themselves. Some of Mercer’s clients may negotiate ‘most favoured nation’ arrangements with asset managers and Mercer would support advisory clients in negotiations seeking to obtain fee benefits from managers.

9. Mercer had continually innovated for the benefit of its clients. Liability Driven Investment (LDI) and, more recently, Cash Flow Driven Investment have been important innovations that allow for better risk management.

10. Clients have been increasingly tendering for project work as well as the ongoing advisory and/or fiduciary mandates.

11. Since 2012, Mercer has won about [✂] fiduciary management clients; around about [✂] of those appointments involved some form of competitive process (this rises to [✂] in the last 18 months). [✂]. Tendering is less prevalent for partial fiduciary management mandates. The process of decision-making through to implementation of fiduciary management typically takes clients about a year.

12. Investment consultants were expected to advise clients on appropriate actions, including whether a move to fiduciary management is appropriate or not. Such advice should be irrespective of whether the advisor offers fiduciary management services or not.

13. The sponsoring employer typically had a role in the investment decisions, in particular, the employer has to be consulted when the scheme’s statement of investment principles is amended. The sponsor’s role varies but the company finance director is now rarely a

member of the pension trustee board (although may attend trustee meetings).

14. The trustees needed to know what the sponsor's view of risk is in order to reach key decisions. They may establish a working group with the sponsor in advance of complex decision-making.

15. There has been an increase in the number of professional trustees in recent years. Around half of Mercer’s clients have a professional trustee. This is consistent with the Pension Regulator’s (TPR's) data on the market.

16. Professional trustees were generally seen to have a positive impact; bringing wider experience to bear. However, there were only a limited choice of professional trustees. In addition, professional trustees are subject to the same regulation as other trustees. As individuals, they bring their own biases (for example, their attitude to particular asset classes) and potential conflicts. Mercer has not experienced any bias demonstrated by a professional trustee towards a professional trustee’s former employer.

17. Encouraging competitive tendering for mandates was generally beneficial; however, mandatory tendering is not seen as useful in increasing competition. From the feedback Mercer has seen, clients are not in general supportive of mandatory tendering as they think it should be their decision as to whether to tender.

18. The incidence of competitive tendering had become more frequent. In addition, the most recent KPMG survey (for 2017), shows that across the market third party involvement in fiduciary management tenders is around 60 per cent.

19. Switching to a new fiduciary manager was likely to take around 4 – 12 weeks to implement depending on the complexity of arrangements. [✂].

Advisory and actuarial services

20. Mercer provided two or more services (actuarial, scheme administration and investment advice) to around [✂] clients. Smaller schemes are more likely to buy several services from one provider,

although some large ones do so too. Internally, Mercer client teams may share research and other resources but there will always be separate senior professionals overseeing and providing each service. [✄].

21. Mercer believed that there should be separate appointments for actuarial mandates and investment consultant / fiduciary management mandates, although these roles could be taken on by the same firm.

22. The client may appoint a number of advisors to assist them in managing their pension fund. Mercer is often expected to work with professionals from other companies and firms.

23. Clients will often make their decision in relation to whom should be appointed based on who is the best advisor; the firm that sits behind the individual advisor may be of secondary importance. So, the benefits that can accrue from appointing an advisor from the same firm to carry out multiple services may not be a primary consideration for the client.

24. In those cases where the same firm has been appointed to provide actuarial services and investment services, then there will be separate senior advisors carrying out these roles – although they may share some internal resources and will work closely together on occasion.

Potential remedies

25. Mercer did not support compulsory tendering, although this was offered to the FCA as part of the undertakings-in-lieu (UILs). Mercer believed that tendering can be beneficial, but believed that the decision to tender should be trustee-led.

26. Mercer did see the benefit of standardised tender templates for smaller clients.

27. An industry group had been working on developing a performance framework for fiduciary management for around two years. It has run working groups but has found it very challenging to be able to measure the performance of one fiduciary manager against another. Mercer believes that this is due to the unique characteristics of each client's benchmark. This gives rise to a significant number of cohorts; for example, there is now consideration of a framework with 130 different

client composite benchmarks. This degree of complexity may make a comparable performance standard unworkable.

28. Mercer believed it should be possible to measure the performance of fiduciary managers against an individual mandate – i.e. how the client's funding level is improving relative to their objectives. Industry standard disclosures in this regard would be relatively straightforward to devise.

29. For investment consultants, the performance of advisors was more difficult to assess as the advisor's recommendations may not have been implemented, on a timely basis or at all. Fees could be scrutinised in different ways, for example, by professional trustees.

30. Mercer supported the development of industry standards for disclosure of fiduciary management fees.

31. Mercer recognised the value in softer measures of benchmarking consultants such as client ratings; however, it considered that publishing these for all firms could be problematic as it may have unintended consequences.

32. Mercer suggested that TPR may wish to look at whether there is additional best practice guidance that could be given to trustees.

Fees and profitability

33. For investment consulting engagements, Mercer typically charged a retainer fee for regular/recurring work and separate project fees for discrete projects. Making direct fee comparisons for advisory work is difficult due to scope of services and differing client needs.

34. When reporting fees to fiduciary management clients, Mercer broke down its fees into three areas: Mercer's fee, the third-party asset management charges and custodian or administrative fees. MiFID II will require greater transparency in relation to fees from the industry, in particular the method of reporting ongoing costs.

In Mercer's experience, others in the market sometimes bundled fiduciary management fees together so that it could be difficult for the client to understand the components of the fee.

35. Developing a fiduciary management offering required considerable investment by Mercer: the establishment of a hub in Dublin and investment in people and technology.

36. [✂].

Conflicts of interest

37. Mercer believed that potential conflicts are inherent in all professional service firms. It recognised these risks and manages them effectively.

38. Mercer had asset managers as clients as they may be part of a larger financial services organisation to which it provided investment consultancy and other services. Mercer has a clear and formal process for rating asset managers, no element of which can be influenced by the income received from asset managers. The staff who research and rate asset managers are only incentivised to the extent that they want to ensure that their highly rated managers perform in accordance with their rating.

39. Mercer believed that a potential conflict existed where asset managers offer a fiduciary management service given they may be incentivised to use their own investment products. Transparency of performance and fees may help to address this conflict.

40. The level of gifts and hospitality had declined significantly across the industry, following a tightening up of regulation by the FCA. Mercer has strengthened its gifts and hospitality policies in 2017, with its policies covering both what employees can accept and what can be offered to clients. Mercer has observed that asset managers and other providers in the market have similarly tightened their practices over recent years. Mercer believed that across the market less is being offered by asset managers and other providers and most firms will accept very little by way of gifts and hospitality.

Barriers to entry and expansion

41. Over the last ten years there have been a number of new entrants to the investment consultancy and fiduciary management markets. Many have different business models and operated in different areas of the market. [✂].

42. Development and use of new technology was reducing the level of investment that new entrants require.

43. [✄].

Master trusts

44. There were over 80 different master trusts in the UK (some using the same administrator), approximately 22 have accreditation from TPR. It is a growing market. Mercer believed there may be consolidation of master trusts in the future.

45. All appointments for master trust provision had a structured process in Mercer's experience. [✄]. It is the employer who makes the decision whether to enter into a master trust.

46. Mercer had a single master trust with three administrators. Mercer's market share is [✄] and they had a policy that they will not take part in a process which would require them to compare their master trust to others. Mercer would-raise Mercer's master trust with clients as part of the options that they have available to them.