

INVESTMENT CONSULTANTS MARKET INVESTIGATION

Summary of hearing with The Law Debenture Pension Trust Corporation plc. (Law Deb) held on 27 November 2017

Role of Law Deb

1. LawDeb explained that they act as trustees of around 200 pension schemes, ranging in size of assets from around £25m to over £1bn. In general, they explained that schemes of under £50m in assets are considerably less likely to use a professional trustee, while the largest schemes might have two - three.
2. LawDeb typically were appointed to a new pension scheme on the basis of a competitive process. They worked for schemes on the basis of an hourly fee or a fixed fee for an agreed range of services. Although some trustees in this sector are appointed in their personal capacity, in the case of LawDeb it is the company that is appointed as trustee and the services are provided by LawDeb directors/staff.

Role of professional trustees

3. LawDeb stated that the need for professional trustees is generally driven by a combination of scarcity of trustee time and the increased complexity of investment and other matters (particularly in a pension liability-driven environment). The scheme will often have objectives when it appoints a professional trustee.
4. LawDeb noted that, out of approximately 6,000 defined benefit (DB) pension schemes in the UK, the majority are small and so will have very light governance mechanisms.
5. LawDeb did not think it would be possible to mandate that every pension scheme should have a professional trustee as this would imply a need for approximately 6,000 trustees. At present, there are just a few hundred.
6. LawDeb explained that professional trustees are not subject to any specific legal duties over and above those that apply to any other pension trustee. For

example, a trustee is under a fiduciary duty under the trust which governs the way that trustees operate schemes and which requires regard to be had to the interests of both members and sponsors. The trust deed and scheme rules set out the trustee's powers and duties which operate alongside the Pensions Act requirements. Trust deeds and scheme rules will typically give trustees wide powers and a broad discretion as to how to invest. There is some variance in their terms, but it is in respect of broadly common themes (for example, as to the appointment of advisers).

7. They were part of a working group with representatives from Association of Professional Pension Trustees (APPT), The Association of Corporate Trustees (TACT), Pensions Management Institute (PMI), Pensions and Lifetime Savings Association (PLSA) and The Pensions Regulator (TPR), aiming to establish a 'kitemark' system for professional trustees.

Demand side for investment consultancy

8. LawDeb noted that investment requirements have become more complex in recent years – schemes can no longer rely on a simple balanced portfolio, but were likely to need to consider interest rate and inflation hedging and use of other complex investment products. They noted that they have sometimes seen investment consultants' (IC) advice leading to an investment strategy being more complex than it needs to be. They added that where trustees don't understand a complex solution they can reject it, alternatively they might accept it without challenge simply because it is given by ICs. However, they acknowledged that complexity can result from what is needed to meet a scheme's long-term objectives and therefore it is not per se a problem.
9. They noted that in the past 20 years, larger schemes have had to build up their investment capability: for example, the in-house pension investment team at [redacted] had grown from three people in 1997 to 15 people in 2017.
10. LawDeb noted that, in general, only the largest schemes with assets over £1bn would typically have in-house investment staff who might represent an alternative to IC. One of the largest, [redacted], has around 12 in-house staff and does not use ICs.
11. They also noted that sponsoring employers are now often purchasers of IC, with most ICs acting as providers in this area.

Competition in investment consultancy

12. LawDeb noted that the IC sector appeared to be generally competitive with some new entrants (such as Cardano and Redington) and others having

grown (for example, firms like LCP) and were now competing with the largest in the market. Barriers to entry are not great. The only challenge to expansion that LawDeb saw was that the market appears quite fluid in terms of which firms compete for which types of client. LawDeb observed that ICs must compete with asset managers for some staff and that this can be a challenge as asset management is well remunerated, however it is also the case that there is a high number of such staff in the market place.

Conflicts of interest

13. LawDeb noted that in a number of cases the sponsoring employer is keen for a pension scheme to 'outsource' its investment decisions to a fiduciary management (FM) arrangement in line with a general corporate trend of outsourcing functions.
14. LawDeb believed that there is a potential conflict of interest for ICs recommending that their clients move to an FM service as the fees per client will be higher as a result. They had observed ICs using their position as a trusted, incumbent adviser to do this and would support the first selection of a FM provider being via a mandatory tender process. However, they believed that this process must be proportionate so it is not a burden for pension schemes. One suggestion would be for schemes to have a duty to explain to members if they have moved into a FM arrangement, how and why it was done.
15. LawDeb had observed a conflict when ICs propose partial FM arrangements for particular areas of investment and recommend their own in-house products. They suggest that this needs guidance to prevent conflicts arising from the IC's position as a trusted adviser. It is important that IC clients know they have options and for there to be a documented discussion with the IC on alternative FM providers. The trustees should take responsibility for ensuring this potential conflict is managed.
16. LawDeb said that they had seen provision of FM by asset managers to work well for schemes and do not have concerns over potential conflicts in this arrangement. They believe that AMs work well under FCA regulation and tend to have strong conflict policies and good compliance and risk management functions.
17. LawDeb said that they had not observed ICs which do not have a FM service failing to propose that to their clients where this might be appropriate. They observed that ICs could face a potential similar conflict in advising whether a scheme should move to a buy-out position but they did not think this was a real problem.

18. LawDeb did not think that gifts & hospitality pose a problem any longer. There has been clear change in recent years, driven by tighter regulation.

Potential remedies

19. When considering potential remedies around tendering, LawDeb believed that tendering for ICs could be costly for pension schemes. They also noted that a lack of switching did not indicate that the scheme is getting a poor service. They added that since the financial crisis all markets had reasonably improved, hence there was not a driver of dissatisfaction to trigger switching IC/FM provider. They did favour schemes having to review their IC service but not necessarily in a formal, prescriptive way.
20. LawDeb said that they were concerned about any system which brings in use of hard performance metrics for ICs, either based on performance of pension schemes, or on client reviews of ICs' performance, as it believes these will distort activity (for example with firms only focusing on meeting the metrics). They noted that net promoter scores are used by DC scheme IGCs.
21. LawDeb also did not believe that IC service/fees can be compared easily given the wide variance of client requirements.
22. One improvement that could be made is for IC reports to be presented in a way that is useful to stakeholders. They had seen examples of very good, as well as very poor, reports. Another area for improvement is that trustees needed to appreciate the drivers of investment trends and the resulting degree of complexity in the necessary investment solutions.
23. LawDeb did believe that performance can be measured for the providers of full FM mandates and it has worked with IC Select on a potential framework for this.
24. LawDeb also believed that it is becoming easier to compare FM provider service/fees.
25. LawDeb favoured greater use of best practice and guidance for trustees and also for ICs, possibly via FCA or other regulation.