Investment Consultants Market Investigation

Working paper: trustee engagement

12 April 2018

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the issues statement and the other working papers which are being published.

These papers do not form the inquiry group's provisional decision report. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional decision report, which is currently scheduled for publication in July 2018, taking into consideration (among other matters) the evidence obtained, responses to the consultation on the issues statement and responses to the working papers as well as other submissions made to us.

Parties wishing to comment on this paper should send their comments to investmentconsultants@cma.gsi.gov.uk by 26 April 2018.

The Competition and Markets Authority has excluded from this published version of the working paper information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂].

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Summary

1. This working paper sets out our initial analysis of trustee engagement with investment consultancy (IC) and fiduciary management (FM). It considers the extent to which pension scheme trustees are able to assess the value for money of alternative providers, and (where necessary) to act on the outcome of that assessment. If there are barriers to trustees' ability to assess different providers and act on this assessment, this may limit their ability to drive effective competition between providers, resulting in higher prices and/or lower quality services than would otherwise be the case.

2. This builds on our previous working paper 'information on fees and quality', which considered the extent to which trustees have access to the necessary information to engage actively with IC and FM providers. It will also be complemented by our analysis of outcomes for trustees, in particular our analysis of gains from engagement which will be set out in a separate working paper.

3. Our primary assessment of trustee engagement focuses on four 'formal' or 'headline' indicators – switching, tendering and/or switching, undertaking a formal review of fees and/or quality, and undertaking an external review of fees and/or quality. We have considered how the level of engagement across these four measures varies by type of scheme. Some emerging results from this analysis are:

(a) Defined Contribution (DC) schemes appear to be significantly less engaged than average. Amongst IC clients for example, the rate of switching for DC schemes is just 16% (compared to the average of 27%), and the rate of switching or tendering is 29% (compared to an average of 41%).

(b) There is some evidence that size of pension scheme is a determinant of engagement. Small schemes are significantly less likely than average to have undertaken a formal review of fees and/or quality, and large schemes are significantly more likely than average to have done so. Further, large schemes are significantly more likely than average to have undertaken at least one of the four actions analysed.

(c) There is some evidence that schemes with an investment sub-committee are more engaged than average. These schemes are significantly more likely than average to have undertaken a formal review of fees and/or quality, and significantly more likely to have undertaken at least one of the four actions analysed.

4. We have compared the relative levels of engagement across IC and FM for each of the four indicators above. With the exception of an external review of fees and/or quality, the CMA survey indicates that levels of engagement are lower in FM on each indicator.[1] It is difficult to draw firm conclusions from these results however, as FM is a relatively new and emerging service. Many schemes have only recently bought FM, and so we might expect formal measures of engagement – such as tendering or switching – to be lower. Although switching rates appear to be lower in FM for example (9% in FM compared to 27% in IC), the average tenure for a provider is approximately the same (around 6-8 years).

5. We acknowledge that switching and tendering rates are not the only measures of engagement, and that low switching rates are not necessarily indicative of low engagement. In addition to these 'headline' indicators of engagement, we have therefore also considered broader measures of engagement such as whether trustees are able to scrutinise and challenge the investment advice they receive, and the role played by other stakeholders such as the scheme sponsor.

6. Third-party research, including work undertaken by the Pensions Regulator (TPR), indicates that many trustees rarely disagree with their investment advisors. TPR's 2015 Trustee Landscape survey found that many lay trustees do not meet the standards of 'knowledge and understanding' expected by the regulator. This is broadly consistent with some of the submissions that we have received from parties, although many parties have submitted that they are regularly challenged by their clients.

7. Some parties have also emphasised the important role played by the scheme sponsor and scheme actuary. This is consistent with the findings of the CMA survey. Amongst IC clients for example, 49% of respondents stated that the scheme sponsor is very important in scrutinising and challenging their investment consultant; 42% also stated that the scheme actuary is very important in this regard.

8. To assess whether there are any significant impediments to trustees in changing their IC or FM provider, we have analysed the process, timings and costs involved with switching. Broadly speaking, the key difference between these two cases is that switching FM provider generally involves an upfront revision to the client's investment strategy; in an IC agreement, changes to

[1] The CMA survey was conducted by IFF Research. In total 966 trustees were surveyed, each on behalf of a trustee board for a trust-based pension scheme with 12+ members. The statistics that relate to FM in this paper are based on responses where the pension scheme was buying FM from a 'confirmed' provider of FM services. A confirmed provider is one that we have confirmed (as part of our investigation) provides FM services. In some cases, results relating to FM may therefore differ from those presented in the IFF research report.

the investment strategy will typically be introduced gradually after the appointment is made.

9. This implies that the initial time and cost required to switch provider will generally be much greater in FM than IC. However, these timings and costs vary considerably on a client-by-client basis, depending in particular on the complexity of the initial portfolio and the extent of change required to achieve the proposed portfolio.

   (a) Estimates submitted by parties indicate that the FM switching process would usually take a number of months. Regarding costs, estimates indicate that typical transaction costs could be in the range of 0.1% to 0.5% of assets under management.

   (b) Excluding legal costs, it is our understanding that the upfront timings and costs for switching provider of IC services are minimal.

10. We note that the existence of potentially high switching costs in FM highlight the importance of competition working well, and active trustee engagement, at the point when a scheme first moves into FM. This is covered in more detail in our working paper on the supply of fiduciary management services by investment consultancy firms.

11. To summarise our emerging findings, there is evidence that levels of engagement vary significantly across pension schemes. DC schemes and small schemes are less likely to engage than others, while pension schemes with certain governance structures (such as the use of investment sub-committees) are more likely to have higher levels of engagement. For FM, our analysis of the switching process indicates that the time and costs involved in switching FM providers can be considerable. Together, this evidence raises potential concerns over the extent to which trustees are able to assess the value for money of their current provider and, in FM, switch to an alternative provider.

12. Finally, we present our emerging thinking on potential remedies in the event that we were to find an adverse effect on competition (AEC). We have grouped these potential remedies into three categories: measures to better inform trustees of switching cost; measures to reduce switching costs and measures to empower and incentivise trustee boards to engage.

13. We welcome further evidence and views on the analysis, emerging findings and potential remedies set out in this document.

Introduction

14. This working paper sets out our initial analysis of trustee engagement. It considers the extent to which trustees are able to assess the value for money of providers, and (where necessary) to act on the outcome of that assessment. This may be through switching provider or improving the terms offered by their current provider.

15. The paper in turn sets out:

- The conceptual framework – outlining the theory of harm we are investigating and the conceptual framework that we have developed (paragraphs 16 to 22).
- Background – summarising the regulatory framework, the characteristics of trustees, their use of IC/FM and their reasons for using IC/FM (paragraphs 23 to 53).
- Headline indicators of engagement – the extent to which trustees have recently switched, tendered and/or switched, or undertaken a formal or external review of their provider (paragraphs 54 to 65).
- Other forms of engagement – the extent to which trustees can challenge and monitor their provider, and the role of other actors such as the scheme sponsor (paragraphs 66 to 89).
- The switching process and costs, with a particular focus on switching between FM providers (paragraphs 90 to 115).
- Potential remedies – outlining our emerging thinking on potential remedies if we were to find an AEC (paragraph 116 to 138).

Conceptual framework

16. This working paper forms a central part of our demand side and information theory of harm. The issues statement summarises this theory of harm as follows:

> Difficulties in customers' ability to effectively assess, compare and switch investment consultants result in weak incentives for investment consultants to compete for customers.

17. We note that trustees act on behalf of underlying members, and their actions and decisions can have a major impact on the retirement incomes of members and pension scheme funding levels. Achieving value for money – in terms of lowering costs and/or improving investment performance – is therefore particularly important in this sector.

18. Further, because of their responsibilities to underlying members, we are interested in whether trustees are able to scrutinise and challenge their investment advisors. This includes analysing whether trustees have the necessary capabilities to fully understand and, where appropriate, challenge specific pieces of investment advice. We also consider the role of the scheme sponsor and other advisors in assisting trustees to do this.

19. We recognise however that trustees also have many other responsibilities and duties which they must fulfil, and which require their engagement.

20. In considering the extent to which customers face difficulties in assessing, comparing and switching investment consultants, we broadly follow the conceptual framework outlined in our market investigations guidelines[2] ('the Guidelines'). The Guidelines state that customers may face difficulties in each of the following areas:

(a) Accessing information (access).

(b) Identifying the best value for money (assess).

(c) Switching services and suppliers (act).[3]

21. The analysis in this paper is primarily concerned with the final two of these areas – whether customers (particularly pension scheme trustees) are able to assess value for money, and whether they are able to act on the outcome of that assessment. Our previous working paper on 'information on fees and quality' covered the 'access' strand of the analysis.

22. To assess value for money, trustees require an understanding of the quality of service they receive, including the quality of investment advice, and whether the fees that they pay are competitive. Understanding the quality of investment advice is particularly challenging, and we are interested in the range of measures that trustees take to evaluate this. We consider for example the extent to which trustees run competitive tenders and conduct formal or external reviews of fees and/or quality. We also consider the role of the scheme sponsor and other advisors in evaluating the service provided by investment consultants.

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[2] *Guidelines for market investigations: Their role, procedures, assessment and remedies* (CC3 (Revised), April 2013).
[3] ibid, paragraphs 296 and 297.

Background

23. In this section we present an overview of the regulatory framework, trustee characteristics, their use of and reasons for using IC and/or FM. The aim is to provide some overall context for assessing trustees' requirements and abilities to monitor and scrutinise their provider, and for assessing value for money.

Regulatory framework

24. Pension trustees' use of, and engagement with, IC and FM providers is determined to a large extent by the legal and regulatory duties they have. Before analysing trustees' characteristics and their levels of engagement, we first provide a brief overview of this regulatory framework.

Key legislative requirements

25. The Pensions Act 2004 (PA04) requires that trustees have appropriate knowledge and understanding of the law relating to pensions and trusts, as well as the principles relating to the funding of pension schemes and the investment of scheme assets.[4]

26. PA04 also requires trustees to be conversant with certain scheme documents, including the statement of investment principles (SIP) and the statement of funding principles (in the case of DB schemes). Trustees must also be conversant with any other document recording policy relating to the administration of the scheme.[5]

27. The Occupational Pension Schemes (Trustees' Knowledge and Understanding) Regulations 2006 state that newly-appointed individual trustees have a period of 6 months from the date of appointment to complete the required learning to fulfil their requirements.[6]

28. Under the Occupational Pension Schemes (Charges and Governance) Regulations 2015,[7] trustees of schemes that offer money purchase benefits (subject to exceptions) have a legal requirement to explain in the annual

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[4] PA04, Sections 247 to 249. In respect of individual trustees, the degree of knowledge and understanding required by PA04 is that appropriate for the purposes of enabling the individual properly to exercise his functions as trustee of any relevant scheme (section 247(5) PA04; see also section 248(6) PA04 for similar provision in the case of corporate trustees).
[5] PA04, Sections 247 and 248.
[6] The Occupational Pension Schemes (Trustees' Knowledge and Understanding) Regs 2006, SI 2006 No. 686, regulation 3.
[7] The Occupational Pension Schemes (Charges and Governance) Regulations 2015, SI 2015 No. 879, regulation 17.

chair's statement how they meet the requirements of having appropriate knowledge and understanding. The statement must also explain how the trustees' combined knowledge and understanding enables them to properly exercise their functions.

29. The trustees of DC schemes are required to carry out a value for members (VfM) assessment at least annually. This must include all services that are paid out of member contributions, including those where costs are shared with the employer.[8] The outcome of the VfM assessment, as well as a list of all member-borne costs and charges of the scheme, must be disclosed in the annual chair's statement.[9,10]

30. Advisors' fees (including those of investment consultants and fiduciary managers) are covered by the VfM requirements if they are at least partially paid for from member contributions.

31. Most importantly, the Pensions Act 1995 (PA95)[11] requires that, when making investments, trustees obtain and consider the written advice of a person they reasonably believe to have the appropriate knowledge and experience of financial matters and investment management. PA95 specifically requires trustees to obtain and consider written advice before preparing or revising a SIP. The SIP must be reviewed at least every three years and without delay after any significant change in investment policy. The Occupational Pension Schemes (Investment) Regulations 2005[12] state that trustees must consult the sponsoring employer when preparing or revising the SIP.

TPR guidelines and recent initiatives

32. TPR has produced 14 'codes of practice', which provide practical guidelines for trustees on how to comply with the legal requirements of pension regulation.[13] In Annex 1 we cover particular aspects of the codes of practice – and accompanying guidance – which directly relate to trustee engagement such as code of practice 7 which relates specifically to 'trustee knowledge and understanding'.

33. As covered in Annex 1, we also note that TPR has recently launched its 21st Century Trusteeship campaign to clarify the regulator's expectations of the

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8 Occupational Pension Schemes (Scheme Administration) Regulations 1996, reg 25(1), SI 2005 No. 1715
9 ibid, reg 23(1)(c), (as above)
10 For further details see COP 13 (the DC code), paragraph 114
11 Sections 35 and 36 PA95.
12 The Occupation Pension Schemes (Investment) Regulations 2005, SI 2005 No. 3378, reg 2(2)(b)
13 TPR notes (e.g. COP 7, p.4) that 'codes of practice are not statements of the law and there is no penalty for failing to comply with them. Nevertheless, codes have legal effect; they must be taken into account by the regulator, a court or tribunal, if they are relevant to what is being decided'.

actions that trustees should take to meet legislative requirements of them and to manage their scheme effectively.

Trustee characteristics

Trustee board composition

34. TPR's 2015 Trustee Landscape survey found that the average number of trustees on a board is three.[14] The vast majority of schemes (88%) have five or fewer trustees on the board, although boards with six to ten members are reasonably common amongst large schemes (22%).[15]

35. TPR's research also found that almost a third (31%) of schemes have just a single trustee (which includes sole corporate trustees). This figure is higher than average for DC schemes (41%) and large schemes (54%). As the PA04 requires that at least one third of trustees, or directors of corporate trustees, must be member nominated,[16] it is our understanding that a sole trustee must be member nominated unless that trustee is a corporate trustee with at least one-third of its directors being member-nominated directors or an exemption applies.

36. TPR's Trustee Landscape survey found that just over half (52%) of schemes have a professional or corporate trustee on the board.[17] Around a quarter (27%) of trustee boards contain *only* professional or corporate trustees. A number of parties have submitted to us that there has been an increase in the number of professional trustees in recent years.

37. The CMA survey indicates that 18% of schemes have an investment sub-committee. As shown in Figure 1 however, this percentage varies considerably across schemes. In particular, both DC schemes and small schemes are considerably less likely to have an investment sub-committee than average.[18]

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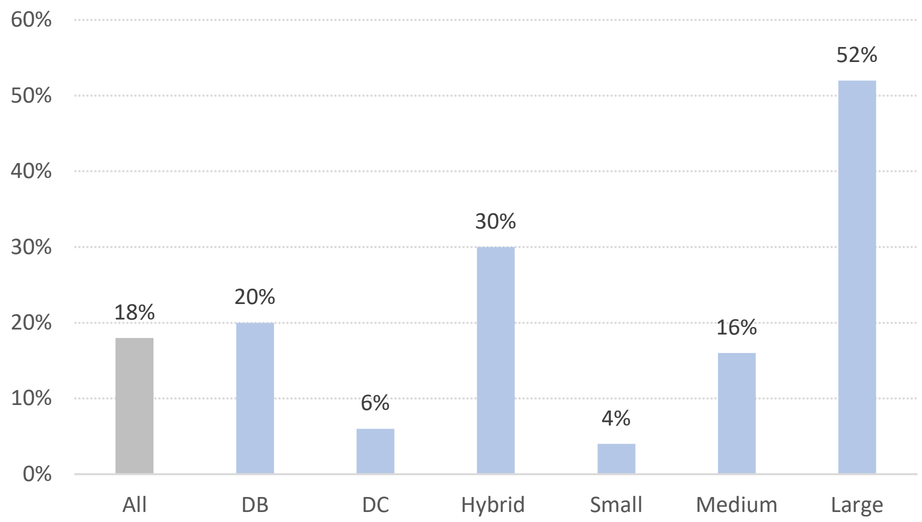
[14] The Trustee Landscape survey interviewed 816 pension scheme trustees.
[15] In the CMA survey and the TPR Trustee Landscape survey, the size of the scheme is based on the number of members. Small schemes are defined as those with 12-99 members, medium schemes are those with 100-999 members, and large schemes are those with 1000+ members.
[16] PA04, Sections 241 and 242, which apply in respect of occupational pension schemes established under a trust (section 243 PA04).
[17] TPR defines a corporate trustee as 'a company which acts as a trustee' (see TPR's glossary). This may be a professional trustee company, although the sponsor itself may be the corporate trustee.
[18] These findings are broadly consistent with evidence from TPR's Trustee Landscape survey, which found that 16% of schemes overall have an investment sub-committee, with 19% of DB schemes and 7% of DC schemes.

Figure 1: The prevalence of investment sub-committees



Source: CMA survey. Question B1: 'Does the scheme have an investment sub-committee?' Bases: all (966), DB (679), DC (125), hybrid (162), small (259), medium (454), large (253).

Frequency of meetings

38. Based on TPR's Trustee Landscape survey results, the majority of trustee boards meet at least every quarter or six months (79% overall), and trustees spend around 11 days a year on average on 'trustee duties'. The frequency of meetings and the time spent on trustee duties appears to be considerably lower for DC schemes and small schemes however:

(a) Amongst DC schemes, just 62% of boards meet at least every 6 months; 6% meet less than annually and 9% have never met. Further, almost half (49%) of DC scheme trustees spend less than 5 days a year on trustee duties.

(b) Amongst small schemes, 62% of boards meet at least every 6 months, and on average trustees spend 9 days a year on their duties.

39. There is limited evidence of the amount of time that trustee boards spend addressing investment issues. Aon's Mapping the Trustee Landscape survey however found that up to a quarter of time at board meetings is typically spent on 'investment matters'.[19]

[19] Research undertaken by Leeds University Business School (LUBS) and Aon. This research is based on an online survey of 197 trustees and scheme managers.

Trustee experience, qualifications and training

40. The CMA survey indicates that trustees for any pension scheme have on average 11 years of experience, which is broadly consistent across different types and sizes of scheme. The survey further found that two thirds of trustees sit on just one board. Professional trustees, accounting for 17% of our sample, on average sit on 16 trustee boards.

41. TPR's Trustee Landscape survey investigated the qualifications held by trustees and their recent levels of training. To summarise their findings:

   (a) Seventy percent of non-professional trustees have a 'relevant' qualification (as described by TPR), which is a professional qualification relating to finance, investments, pensions, law or actuarial science. Eighty nine percent of professional or corporate trustees have at least one of these qualifications.

   (b) The average level of qualifications is lower for DC schemes and small schemes. Amongst non-professional trustees/directors of corporate trustees, 39% of DC trustees/directors and 41% of small scheme trustees/directors do not have any of the above qualifications (compared to 30% overall). Amongst professional trustees/directors, 20% of DC trustees and 18% of small scheme trustees/directors do not have any of the above qualifications (compared to 11% overall).

   (c) Half of all respondents stated that at least some of their non-professional trustees had undertaken formal, structured training within the last 12 months. This number was lower for small schemes (37%) and DC schemes (32%). The most common source of training was TPR's trustee toolkit.

Knowledge and application of regulatory guidance

42. Annex 1 outlines TPR's codes of practice and related guidance that assist trustees in meeting their legislative requirements. TPR's Trustee Landscape survey found that whilst almost all trustees were aware of the codes of practice (94%), or had read them (84%), a large number of schemes did not believe that all members of the board met the standards set out in code of practice 7 ('trustee knowledge and understanding').

43. Less than half of respondents (49%) stated that all non-professional trustees on their board met the standards required in the code of practice 7. This number was substantially lower for small schemes (38%) and DC schemes (36%).

Stakeholder submissions on trustee characteristics

44. Many parties submitted that the governance of pension schemes varies significantly. Mercer for example explained that larger schemes are typically better resourced and more likely to have investment sub-committees, professional trustees and access to additional resources such as in-house investment teams. Smaller schemes tend to have fewer resources, particularly in terms of the time available to consider investment matters. However, Mercer submitted that this does not indicate that smaller schemes have less expertise than larger schemes; this depends on the skills and expertise of the individual trustees.[20]

45. Russell Investments submitted that, at an individual level, trustees brought a wide range of knowledge and experiences across a diverse range of areas. The role of a trustee requires dealing with a wide range of issues including legal, investment and finance and as a result it is challenging for individual trustees to be an expert in all areas. Larger schemes tend to have trustees with greater experience.[21]

46. Although the skills and capabilities of trustees can vary significantly, many parties emphasised that their clients are intelligent, committed and diligent, and therefore able to make a well-informed decision when acquiring IC and/or FM services.

   (a) Aon, for example, submitted that research undertaken with Leeds University Business School found that trustees are experienced, well-educated and financially sophisticated:

      (i) four out of five trustees are educated to degree-level or higher;

      (ii) their financial literacy is at the highest level;

      (iii) they have an average of 10 years' experience as trustees.[22]

Use of investment consultants and fiduciary managers

IC services

47. Overall, 73% of schemes from the CMA survey use IC services.[23] As shown in Figure 2, this figure varies considerably depending on the size and type of

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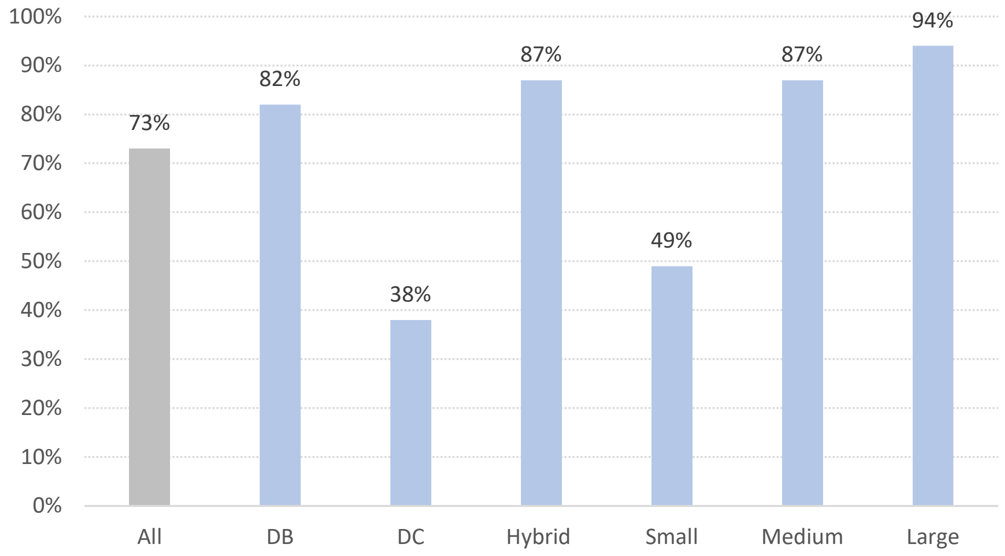
[20] Source: Mercer's Issues Statement response.
[21] Source: Russell Investment's hearing summary.
[22] Source: Aon's Issues Statement response.
[23] Sections 35 and 36 PA95 require trustees to obtain and consider written advice when making investments or preparing/revising the SIP. This advice does not necessarily have to be provided by investment consultants

the scheme. Only half of small schemes use investment consultants, compared to almost all large schemes. Similarly, just 38% of DC schemes use investment consultants, compared to 82% of DB schemes and 87% of hybrid schemes.

Figure 2: Proportion of schemes using IC services



Source: CMA survey. Question A7_1: 'Does the board of trustees buy investment consultancy services?'
Bases: all (966), DB (679), DC (125), hybrid (162), small (259), medium (454), large (253).

48. The variation in the types of scheme using IC services is reflected in the client data that we have collected from parties. Table 1 shows the number of clients, revenues and average revenue per client for DB and DC schemes, for each of the 5 largest IC firms (based on 2016 revenues).

49. We highlight two points from Table 1:

(a) First, each firm has a much greater number of DB clients than DC clients. This is also reflected in total revenues.

(b) Second, average revenues per client are also generally much higher for DB schemes than DC schemes. Therefore, even amongst schemes that use IC services, DB schemes appear to use investment consultants much more than DC schemes.

however. TPR's Trustee Landscape survey for example found that 21% of schemes use independent financial advisors (although it does not state what they are used for). This percentage is higher than average amongst small schemes (30%) and DC schemes (26%).

Table 1: Number of clients and revenues by provider, IC

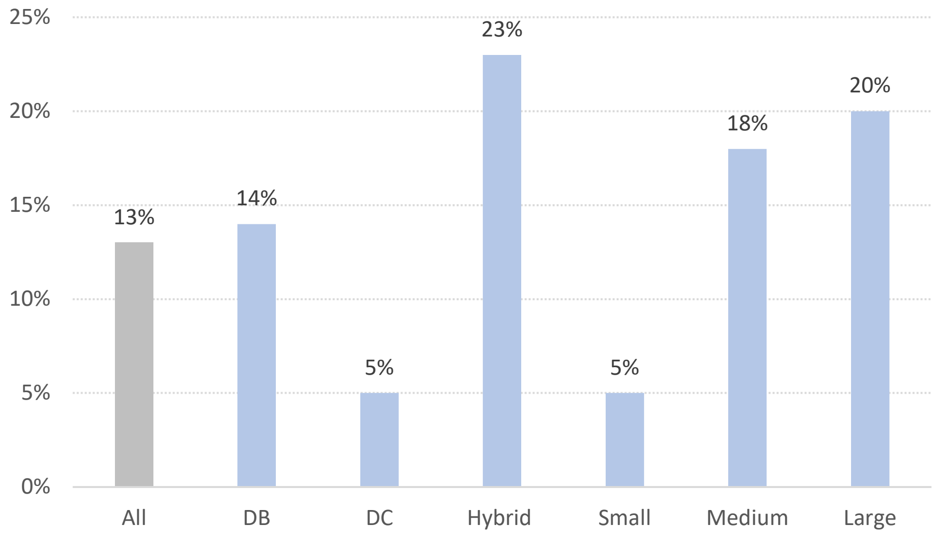
	Clients		*Total revenues (millions)*		*Revenues per client (thousands)*	
	DB	*DC*	*DB*	*DC*	*DB*	*DC*
Aon	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Hymans	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
LCP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Mercer	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
WTW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis using data collected from parties

Fiduciary management

50. As shown in Figure 3, the CMA survey found that 13% of schemes use FM.[24] Similarly to IC services, this figure is considerably lower amongst DC schemes (5%) and small schemes (5%).

Figure 3: Proportion of schemes using FM



Source: CMA survey. Question A7_2: 'Does the board of trustees buy fiduciary management services?'
Bases: all (966), DB (679), DC (125), hybrid (162), small (259), medium (454), large (253).

51. Again, as in IC services, Table 2 shows that the total number of clients, total revenues and average revenues per client for the 5 largest firms (based on 2016 revenues) are all considerably higher for DB schemes than DC schemes.

[24] The CMA survey statistics that relate to FM are based on responses where the pension scheme was buying FM from a 'confirmed' provider of FM services. A confirmed provider is one that we have confirmed (as part of our investigation) does indeed provide FM services.

Table 2: Number of clients and revenues by provider, FM

	Clients		*Total revenues (millions)*		*Revenues per client (thousands)*	
	DB	*DC*	*DB*	*DC*	*DB*	*DC*
Aon	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Mercer	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
River & M.	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Russell Inv.	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
WTW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis using data collected from parties

Reasons for using investment consultants and fiduciary managers

Investment consultancy

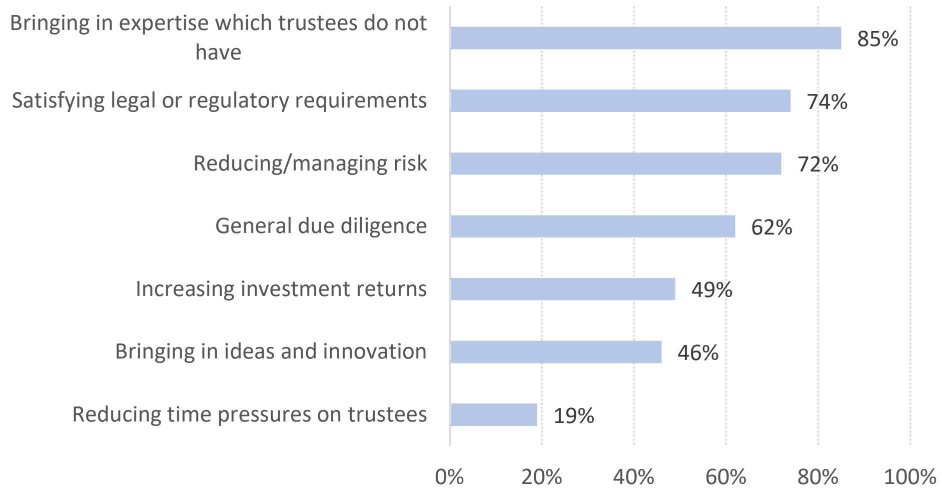
52. Figure 4 shows the main reasons that trustees provided for using investment consultants, based on the CMA survey.[25] We note two points in particular:

(a) First, reducing or managing risk appears to be a more important motivation for using investment consultants (on average) than increasing overall investment returns. This is true across all types (DB/DC/hybrid) and sizes (small/medium/large) of scheme.

(b) Second, 'satisfying legal or regulatory requirements' is one of the key motivations for using investment consultants. Although not displayed in the figure, this percentage is even higher amongst DC schemes – 90% of DC scheme respondents stated that this was a 'very important' motivation compared to an average of 74%.

[25] This is based on the percentage of respondents stating that a particular factor is a 'very important' reason for using investment consultants.

Figure 4: Reasons for using investment consultants

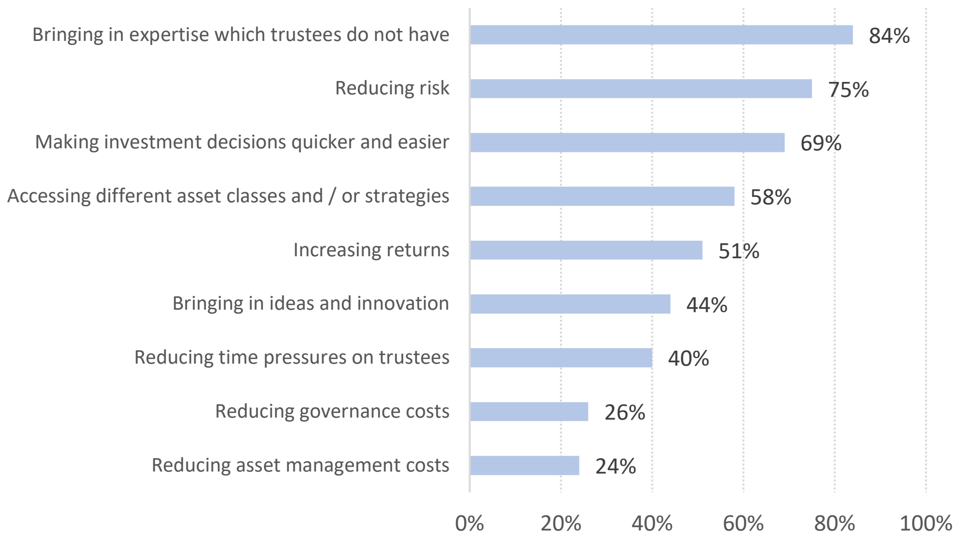


Source: CMA survey. Question C1: 'So, how important is [...] as a reason to buy investment consultancy services?' Base: all (709). The chart shows the percentage that responded 'very important'.

Fiduciary management

53. As demonstrated in Figure 5, the motivations for using FM are broadly similar to those for IC. In particular, the two most important factors are to bring in additional expertise and to reduce risk. Trustees also value making investment decisions quicker and easier, and gaining access to different asset classes and strategies.

Figure 5: Reasons for using FM



Source: CMA survey. Question K1: 'How important is each of the following as a reasons to [buy fiduciary management]?' Base: all (145). The chart shows the percentage that responded 'very important'.

Headline indicators of engagement

54. In this section we analyse how levels of engagement vary across different types of customer and provider. We focus in particular on four 'headline' indicators of engagement:

(a) Switching from one provider to another. As noted in the Guidelines, the ability to switch provider is important in enabling customers to receive the best value for money. The CMA survey asked trustees whether they had switched within the last five years.

(b) Switching and/or tendering.[26] Even if a customer chooses not to switch, organising a tender may enable it to extract lower fees or a higher quality of service from its current provider. Tendering also enables customers to formally assess the alternative offers available in the market. The CMA survey asked trustees whether they had switched and/or tendered within the last five years.

(c) A formal review of fees and/or quality. This can be an important mechanism for ensuring that the incumbent provider is offering value for money. As a result of such a review, customers may be able to negotiate lower fees or an improved level of service. The CMA survey asked trustees whether they had undertaken a formal review of fees and/or quality within the last three years.

(d) An external review of fees and/or quality. This may be a more formal or rigorous assessment of the value for money offered by the incumbent provider. The CMA survey asked trustees whether they had undertaken an external review of fees and/or quality within the last three years.

Investment consultancy

55. Table 3 presents the levels of engagement across each of the 4 'headline' indicators discussed above based on the CMA survey.

56. In each column, we first show (row 1) the percentage of all schemes that have undertaken the relevant action within the reference period.[27] Within each column, we then show how the level of engagement differs from average for different types of scheme. These numbers are percentage point differences – e.g. in column 1 the rate of switching across all schemes is 27%; the entry of

[26] We consider switching and tendering jointly as this captures the overall group of trustees/schemes that have either changed provider or actively searched and considered the alternative offers available in the market.
[27] This is the last five years for switching and tendering, and the last three years for a formal or external review of fees and quality.

‘+1’ in the row for DB schemes indicates that the rate of switching for DB schemes is 28%.

57. We have tested the statistical significance of these differences, and reported results at the 5% significance level – positive and significant differences from average are shown in green, and negative and significant differences are shown in red.

58. We highlight the following results from Table 3:

(a) DC schemes are significantly less likely to have engaged on any of the four headline indicators of engagement. The rate of switching for example falls from 27% on average to 16% for DC schemes, and the rate of switching and/or tendering falls from 41% to 29%.

(b) There is some evidence that scheme size is correlated with engagement. Smaller schemes are less likely than average to have undertaken a formal review of fees and/or quality, whereas large schemes are more likely than average to have done so. Large schemes are also significantly more likely to have undertaken at least one of the four actions. Further, we note that although not all indicators are statistically significant, there is a clear and consistent pattern in that larger schemes are more engaged than average across each measure.

(c) There is some evidence that schemes with an investment sub-committee are more engaged than average. In particular, such schemes are more likely to have undertaken a formal review of fees and/or quality, and more likely to have undertaken at least one of the four actions.

(d) There is little evidence that bundling services (e.g. by purchasing IC and actuarial services from the same provider) reduces engagement. Customers that purchase ‘nothing else’ from their investment consultant for example are no more likely than average to switch and/or tender, and are less likely to undertake an external review of fees and/or quality.[28] Interestingly, those schemes that also purchase FM services from the same provider are more likely to undertake an external review of fees and/or quality.

59. Table 3 also indicates that rates of switching, and rates of switching or tendering, are lower than average amongst clients of the three largest providers. Actually, this result shows that trustees were less likely than

[28] We have also tested whether schemes that specifically bundle IC, actuarial services and administration together are more or less likely to be engaged than others. We have found no evidence that this is the case.

average to have switched *to* one of the three largest providers. This is because trustees were asked to identify their *current* provider, and subsequently asked about their *previous* switching patterns (i.e. whether they had switched within the last five years). This result is therefore consistent with declining market shares of the three largest providers over the last five years (based on the number of clients).

60. In Annex 2 we run some simple regressions to control simultaneously for the various scheme and provider characteristics analysed in Table 3. Doing so does not substantively change the main results highlighted above.

Table 3: Headline indicators of engagement – investment consultancy

	Obs.	*Switched*	*Switched and/or tendered*	*Formal review of fees and/or quality*	*External review of fees and/or quality*	*Any of these actions*
All schemes	**783**	**27%**	**41%**	**63%**	**15%**	**73%**
Type of scheme						
DB	567	+1	0	+1	0	+1
DC	70	-11*	-12*	-15*	-9*	-12
Hybrid	146	+2	+7	+5	+4	+5
Size of scheme						
Small	149	+3	0	-10*	-1	-8
Medium	396	-3	-1	+1	-1	-1
Large	238	+2	+2	+9*	+3	+9*
Investment subcommittee						
Yes	196	-5	-4	+11*	+1	+8*
No	587	+1	+1	-3	0	-3
Type of provider						
3 largest	194	-14*	-9*	-1	+1	-5
Other	589	+5*	+3	0	0	+2
Number of services purchased						
Fewer than 3	50	-2	-6	-15	-10*	-10
Between 3 and 5	289	-3	-3	-6*	-3	-4
Between 6 and 7	444	+2	+3	+6*	+3	+4
Other services purchased from IC provider						
Actuarial services	445	-3	-2	+1	-1	+1
FM	99	+6	+9	+6	+11*	+5
Scheme administration	411	-4	-2	-2	-2	-2
Nothing else	189	+2	0	-4	-5*	0

Source: CMA analysis based on the CMA survey.
*Note: * indicates a statistically significant difference from 'all' (p<0.05). The numbers in each cell (unless a % is indicated) are percentage point differences from the overall percentage for the relevant column. We measure rates of switching and/or tendering over the last five years, and formal/external reviews of fees and/or quality over the last three years.*

Fiduciary management

61. Due to the low numbers of observations for most sub-categories, we are not able to replicate the results in Table 3 for FM. Instead, in Table 4 we present the overall levels of engagement in FM across the four headline indicators, and compare these to the levels in IC.

62. Table 4 indicates that the overall rate of switching is lower in FM than IC (9% / 27%). This may reflect the fact that FM is an emerging service however. Indeed, the CMA survey found that the average tenure of current FM providers is six years, compared to eight years in IC.[29]

63. To account for the fact that FM is a growing market, we can adjust the switching rate by removing those schemes that have recently joined FM. To do so, we remove schemes that have been with their current provider less than five years, and have not switched within the last five years.[30] When we do this, the rate of switching increases to 17%. An equivalent exercise for IC services increases that switching rate to 30%.

64. With the above adjustments in mind, we note that each of the other headline measures of engagement are lower in FM than IC, with the exception of an external review of fees and/or quality (which is 22% compared to 15%).

65. We have not presented disaggregated results for FM due to low numbers within each category. Due to these low numbers, we do not place weight on the specific percentages, although we highlight the following results:

   (a) There is some evidence that schemes with an investment sub-committee are more engaged than others. Such schemes are significantly more likely than average to have undertaken a formal review of fees and/or quality, and significantly more likely to have undertaken at least one of the four actions in the table.[31]

   (b) Large schemes are significantly more likely than average to have undertaken a formal review of fees and/or quality.[32]

[29] Question C3: 'How long has the board of trustees bought investment consultancy from your investment consultant?' (base = 783). Question K3: 'How long has the board of trustees bought fiduciary management from your fiduciary manager?' (base = 145).
[30] From the survey, we do not know when a scheme first joined FM. Our approach removes schemes that, based on their survey response, have joined FM within the last five years. It is also possible that some of the schemes that switched also joined FM within the last 5 years. We do not have the information to remove such schemes.
[31] 37 of the 145 schemes have an investment sub-committee. For these schemes, the percentage that undertook a formal review of fees and/or quality increases to 75%, and the percentage that undertook none of the actions falls to 17%.
[32] 50 of the 145 schemes are 'large'. For these schemes, the percentage that undertook a formal review of fees and/or quality increases to 69%.

Table 4: Comparative levels of engagement – IC and FM

	Obs.	*Switched*	*Switched and/or tendered*	*Formal review of fees and/or quality*	*External review of fees and/or quality*	*Any of these actions*
IC	783	27%	41%	63%	15%	73%
FM	145	9%	37%	53%	22%	69%

Source: CMA analysis based on the survey. We measure rates of switching and/or tendering over the last 5 years, and formal/external reviews of fees and/or quality over the last 3 years.

Other forms of engagement

66. In this section we consider additional forms of engagement, beyond the 'headline' indicators analysed above. In particular, we consider the extent to which trustees challenge their investment consultant or fiduciary manager (in terms of both the service provided and the investment advice provided), the ease with which trustees feel they can monitor the fees and quality of their provider, and the role of other key participants – in particular the scheme sponsor and actuary.

Challenging investment consultants

67. In addition to the formal or 'headline' indicators of engagement discussed above, trustees may challenge their provider to improve the terms of service. This may relate to the fees charged, and/or the quality of service provided. In the CMA survey, 70% of respondents stated that they had challenged their investment consultant to improve their terms within the last 3 years; 45% of those within FM had done so.

68. Trustees may also challenge the actual investment advice they receive from their provider. As noted in paragraph 18, the investment decisions made by trustees can have a major impact on the retirement incomes of underlying members and scheme funding levels – we are therefore interested in the extent to which they can understand and scrutinise the investment advice they receive. Although we have little direct evidence on this point, the following evidence implies that many trustees only rarely disagree with the advice of their advisors:

    (a) TPR's Trustee Landscape survey found that 11% of respondents 'never disagree', and a further 57% 'rarely disagree', with their investment consultant.

    (b) Research undertaken in 2016 by Aon and Leeds University Business School found that 76% of trustees said that they do not often reject the

recommendations of their investment consultant. In addition, almost 40% of trustees said that they ‘never’ or ‘not often’ consider alternatives to the investment consultant’s recommendations. This percentage was highest amongst small schemes (those with assets below £100 million). This result may be in part due to the interactions between trustees and their investment consultants through the development of the consultant’s advice.

69. Several parties however submitted to us that they are frequently challenged by their clients. For example:

(a) BBS and Baillie Gifford submitted that given the increased use of professional trustees, trustee boards are now more likely to challenge the advice that their investment consultants provide. However, Baillie Gifford added that it remains difficult for trustees to act against such advice as it opens them to future liabilities.[33]

(b) WTW emphasised that most of its clients are active and engaged and competitive tendering is widespread in the industry.[34]

70. Asset managers who attended a CMA roundtable discussion which was held as part of this investigation told us that they believe that some pension scheme trustees generally lack sufficient investment expertise to take complex financial decisions, although they noted that there are exceptions to this and that the presence of professional trustees can facilitate better decision-making.[35] This view is supported by SEI Investments who submitted that ‘trustees did not, in general, have the skills and knowledge to allow them to effectively challenge their advisors’.[36] Further, PLSA submitted that the UK has a highly fragmented pensions scheme, where many smaller schemes do not have the governance capacity and necessary investment expertise to deal with the many challenges facing both DB and DC schemes.[37]

71. Law Deb submitted that on some occasions trustees might accept advice without challenge simply because it is given by investment consultants.[38]

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[33] Source: BBS’s and Baillie Gifford’s hearing summaries.
[34] Source: WTW’s hearing summary.
[35] Source: Asset Manager Roundtable summary.
[36] Source: SEI Investment’s hearing summary.
[37] Source: PLSA’s Issues Statement response.
[38] Source: Law Deb’ hearing note.

BlackRock[39] also submitted that it is uncommon for trustees to act contrary to the PA95 advice they receive from their investment consultant.[40]

Monitoring performance and fees

72. In our working paper analysing the information that trustees receive on fees and quality, we assessed the extent to which trustees felt that they could monitor fees and the performance of their scheme, as well as the fees that they pay. We summarise some of the emerging findings presented in that paper:

(a) The CMA survey found that over half of respondents found it 'very easy' to monitor the performance of their scheme or investments (64% in IC and 63% in FM), and around a third found it 'fairly easy' (30% in IC and 29% in FM).[41]

(b) The CMA survey found that a number of pension schemes face difficulties in monitoring the fees that they pay to their investment consultant or fiduciary manager, and to third parties. In IC for example, 7% of trustees find it 'not very easy' to monitor the fees paid to their investment consultant, and 16% find it 'not very easy' to monitor the fees paid to third parties. In FM, these figures are 11% and 22% respectively.

(c) Our document review found that trustees typically receive quarterly 'performance reports', which usually include information on overall scheme performance. Detailed information on performance is also provided during strategic reviews. Regarding fees, our document review indicated that information on fees is generally less transparent in FM than IC, and information on third party fees is often limited.

73. Regarding DC schemes in particular, we found that many schemes do not appear to be regularly monitoring 'member outcomes' – i.e. regularly assessing how investment performance impacts different members of the scheme.[42] We also noted (based on recent TPR research) that a number of

[39] Source: BlackRock's Issues Statement response.
[40] Trustees have a duty under s36(3) PA95, before actually investing, to obtain and consider written 'proper advice' on the question of whether the investment is satisfactory, so far as relating to the suitability of investments, and to the principles contained in the statement of investment principles.
[41] The FM results have changed slightly from those reported in our previous working paper. This is because we have now restricted the FM sample to schemes using 'confirmed' providers of FM services.
[42] As noted in the working paper, TPR guidance emphasises that trustees should consider how investment performance has impacted different members of the scheme. Our document review however indicated that few schemes do this on a regular basis.

DC schemes do not appear to be complying with their value for members requirements.[43]

74. The CMA survey also asked respondents how easy it is to monitor the overall quality of service received from their investment consultant/fiduciary manager. The results are shown in Table 5. In both IC and FM, the vast majority of respondents stated that it is 'very easy' or 'fairly easy' to monitor the overall quality of service provided.

Table 5: Ease of monitoring the overall quality of service

	Obs.	*Very easy*	*Fairly easy*	*Not very easy*	*Not at all easy*	*DK*	*NA*
IC	783	45	44	8	2	1	1
FM	145	50	41	5	1	3	.

Source: CMA survey. All entries are percentages.

The role of the sponsor and other advisors

75. Trustees are supported in their role by the scheme sponsor and a number of other advisors and professionals. These can include actuaries, legal advisors, administrators, covenant advisors and internal pension teams. In this section we focus on the role of these participants in monitoring and scrutinising investment consultants and fiduciary managers.

76. Several parties have also submitted that challenges and reviews sometimes do not come from the trustees themselves. Other participants such as third-party evaluators, scheme actuaries, sponsoring employees and their appointed investment banks will investigate or are frequently involved in reviewing investment consultants' advice.

The scheme sponsor

77. Scheme sponsors play a formal role in monitoring the investment advice that trustees receive, in that trustees are required to consult the sponsor when revising the scheme's SIP, which must be done at least every 3 years.[44]

78. Sponsors can also play a more active role in monitoring the investment decisions of trustees. In our client document review for example, we have seen a case in which the sponsor asked to be updated on the impact of a

[43] Recent TPR research found that the value for members requirements were only fully met by 20% of small schemes and 31% of large schemes.
[44] S35(1)(b) of PA95 and the Occupational Pension Schemes (Investment) Regulations 2005, SI 2005 No. 3378.

proposed change to the investment strategy on fees, and another in which the investment consultant wrote to the employer to explain recent developments in the investment strategy and funding level.

79. In some cases, sponsors may hire their own investment consultant. For some providers, this an important source of revenue – sponsors accounted for around [✂]% of Mercer's revenues in 2016 for example.[45] It is our understanding that sponsors typically hire consultants for advice on a particular issue, rather than using them on an ongoing basis.[46]

80. In the CMA survey, 42% of respondents stated that the scheme sponsor is 'very important' in monitoring and scrutinising their investment consultant (38% in FM). A further 32% (in both IC and FM) said that the sponsor is 'fairly important' in this regard.

81. We note however that trustees of DC schemes were considerably less likely to consider the sponsor to be 'very important' in monitoring and scrutinising their investment consultant – 30% compared to 42% overall (based on IC clients). This is perhaps unsurprising given that the sponsor does not have a direct financial interest in the performance of a DC scheme in the same way that it does for a DB scheme.

The scheme actuary

82. Broadly speaking, the role of an actuary is to analyse the liability side of a DB pension scheme, whereas the role of the investment consultant is to analyse the asset side of the scheme. Inevitably there is some overlap in these roles; based on responses to our information requests, we understand that it is common for actuaries to have at least some involvement in the following work of investment consultants:

(a) Journey planning. This involves analysing how the funding level of the pension scheme is likely to change over time and setting appropriate targets. Actuarial input is particularly important in understanding future liability movements.

(b) De-risking triggers. A de-risking strategy requires input from the actuary on suitable long-term targets and timescales. De-risking triggers may also impact the actuarial assessment by altering the calculation of present-value liabilities.

[45] For many providers, this figure is much smaller – eg [✂] for both Aon and WTW in 2016.
[46] Source: parties' submissions to the CMA.

(c) Hedging strategies. Actuaries can advise on the expected impact of interest rates and inflation on the funding ratio, and on the design of suitable hedging strategies.

83. Around half of the respondents to the CMA survey said that the scheme actuary was 'very important' in scrutinising and challenging their investment consultant (49%) or fiduciary manager (48%). A further 22% (IC) and 33% (FM) said that the actuary was 'fairly important' in this regard.

84. We also note however that it is common for IC and actuarial services to be purchased from the same provider. The CMA survey indicates that 55% of schemes that purchase IC also purchase actuarial services from the same provider.

Other advisors

85. The CMA survey asked respondents how important other advisors, both internal and external, were in monitoring and scrutinising their investment consultant. Overall, fewer schemes see such advisors as important than the numbers who see the sponsor or actuary as important:

(a) On average, 14% (IC) and 11% (FM) of all trustees responded that in-house advisors were 'very important' for monitoring and scrutinising their investment consultant. A further 21% (IC) and 28% (FM) responded that they were 'fairly important'. We have found that only the very largest pension schemes typically employ in-house advisors, mostly those with assets above £1bn.

(b) On average, 22% (IC) and 26% (FM) of trustees responded that external advisors were 'very important' for monitoring and scrutinising their investment consultant. A further 24% (IC) and 26% (FM) responded that they were 'fairly important'.

86. A number of schemes use dedicated third party evaluators (TPEs) when tendering, and/or to monitor their current provider. The CMA survey found that 31% of schemes used a TPE when tendering for IC services, and 59% used a TPE when tendering for FM (when moving into FM for the first time).

87. Figures from the latest KPMG FM Survey found that 60% of new FM appointments were advised by an independent third party in 2017. They also found that 17% of schemes use a 'third party overseer' in conjunction with their fiduciary manager.

Multiple investment consultants

88. The use of multiple investment consultants can provide a competitive constraint on each provider by enabling trustees to compare the level of fees and quality, and through challenging and scrutinising each other's advice. The CMA survey however found that the vast majority of schemes (91%) use a single investment consultant; 5% use two providers and just 1% use three or more.

89. We would expect that larger schemes are more likely to use multiple consultants than smaller schemes. This is partly reflected in the CMA survey, with 9% of large schemes using two or more providers, compared with 5% of small schemes.

The switching process and costs

90. In this section we consider the process, timings and costs involved when switching investment consultant or fiduciary manager. As noted in our Guidelines, the ability for customers to switch provider is important in enabling them to achieve the best value for money and for competition to work effectively.[47]

91. In the case of IC, our findings are based on the responses of parties to our issues statement, hearings held to date, and the FM information request referred to below (which also covered the switching process for IC services). Further, the CMA survey asked respondents about their own experiences of switching investment consultant.

92. In the case of FM, our findings are based primarily on the responses of 14 major FM providers to a series of questions issued to them in February 2018. We are proposing further follow-up questions with a number of trustees from the CMA survey on their experiences of switching FM provider.

Switching investment consultant

93. In principle, switching investment consultant can be achieved by signing an 'IC agreement' or 'engagement letter' with the new provider. This will set out the scope of the work and associated fees. Other than any legal costs incurred, the switch can occur at zero cost.

94. In practice, it is likely that – as in FM (below) – the switch of advisor will ultimately result in changes to the investment strategy. The key difference is

[47] CC3 (Revised), paragraph 296.

that in IC, these changes will typically occur gradually. Mercer has submitted for example that in FM, a revised investment strategy is typically agreed with the incoming FM provider *prior* to the transfer to the new provider in order to minimise transaction costs; in IC any such changes will occur *after* the change of provider.

95. The ultimate costs of switching investment consultant are therefore dependent on the extent of changes to the underlying portfolio. Cardano for example submitted that whilst the initial switching costs will typically be higher in FM, over time a new investment consultant will advise on changes to the portfolio and this will also incur transaction costs. They stated that transaction costs may ultimately be lower in FM, because asset transitions are managed by specialist teams that work to reduce 'frictional' costs (eg out-of-market risks).

Survey responses

96. As part of the CMA survey, respondents who had switched investment consultant within the last five years were asked how easy they found the process. Overall, 47% of respondents said that they found the process 'very easy', 35% found it 'fairly easy', 9% found it 'not very easy' and 2% found it 'not at all easy'.[48]

97. The same respondents were asked what, if anything, would make the switching process easier (this was an open question). 57% responded that nothing would make the switching process easier; the next most common answer was 'better communication between parties' (10%).

Switching fiduciary manager

Overview

98. For context, we note that switching FM provider typically involves a considerable upfront revision to the client's investment strategy; this generally requires assets to be moved from one set of funds to another. Due to this revision, and the potentially costly transfer of assets, the switching process usually involves both a planning phase and an implementation phase. Both of these phases can be time-consuming, although monetary costs are mostly incurred during the implementation phase.

[48] This is based on 137 respondents. Most sub-groups are too small to present meaningful results.

99. In Annex 3 we detail the planning and implementation phases in turn. We focus in particular on full FM clients, although we briefly consider how the process differs for partial FM clients.[49]

100. Both the overall timings and monetary costs of switching vary considerably on a client-by-client basis. The key drivers of these timings and costs are the type of assets held in the initial portfolio (highly illiquid assets for example typically being slow and expensive to transfer) and the extent of overlap between the initial and proposed portfolios.

101. In terms of timings, estimates submitted by parties indicate that the overall process would typically take a number of months. In the planning phase for example, the client and provider need to agree upon a new investment strategy and then the specific terms of the contract ('investment management agreement' (IMA)). In the implementation phase, assets need to be transferred from the initial to the new portfolio. Depending on the types of assets held, this can take anywhere from a number of days to a number of months.

102. Regarding costs, estimates indicate that typical transaction costs could be in the range of 0.1% to 0.5% of assets. For context, this range implies transaction costs of between £100,000 and £500,000 for a pension scheme with £100 million of assets.

103. We also note that the annual cost of a full FM service (excluding asset management costs) might typically be in the range of 0.2% to 0.3% of assets.[50] Switching costs could therefore be equivalent to an additional year's worth of FM fees.

Switching clauses in the contract

104. Most contracts (IMAs) include a minimum notice period, which is typically set at 30 days (e.g. Mercer, Russell Investments, SEI Investments), [✂]. BlackRock submitted that notice periods are negotiated on a client-by-client basis.

105. Mercer submitted that the notice period should not affect the switching timeline, as this is typically much shorter than the time taken for clients to be in a position to move assets. They also submitted that their standard IMA

[49] As for IC, the CMA survey asked recent FM switchers how easy they found the process. However we have a very limited number of respondents amongst confirmed FM providers and so have not discussed the results here.
[50] The Ernst & Young FM Fees Survey 2017 estimates a median FM fee (excluding investment management costs) of around 0.2-0.3% of assets per year, and overall fees (including investment management costs) of around 0.5-0.7% per year (for clients up to £250 million).

allows for the termination of the FM appointment upon full redemption of the client's assets from Mercer funds.

106. WTW submitted that their standard (template) contract includes a [✀] minimum term, which is due to the significant upfront costs associated with taking on a client. [✀]. Termination fees can be applied if the client terminates a contract before a minimum term has expired.

Information provided in tenders

107. Many, but not all, of the FM tenders that we reviewed for our previous working paper on information on fees and quality asked firms to estimate the transition and exit fees likely to be incurred as part of the switch.

108. The level of detail provided in response to such questions varies across bids. In some cases, the firm does not provide an estimate of transaction costs on the grounds that they are difficult to estimate in advance. In some other cases, the firm may provide a specific figure (as a percentage of assets), but note that this represents a broad estimate.

Stakeholder views on switching

109. Many parties submitted that the cost of switching investment consultant is low. For example:

(a) Aon stated that 'the costs associated with switching (including non-monetary costs such as time and resources) are low. Transitioning a client is quick (no more than a few weeks) and clients bear no significant fees for any transitional activities (whether exit costs from the incumbent provider, or on-boarding costs of the new provider)'.[51]

110. Redington, however submitted that in its experience with IC clients, 'prospective clients do find it hard to switch investment consultants, frequently anticipating that the costs (both direct and indirect) and the time taken to switch will be greater than they are in practice'.[52]

111. Some parties submitted that switching fiduciary provider can be more complex and costly, although this depends on the specifics of the scheme. For example:

(a) LCP highlighted that, when switching full fiduciary providers, some portfolios include illiquid assets that could take many months to liquidate.

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[51] Source: Aon's Issues Statement response.
[52] Source: Redington's Issues Statement response.

Thus, in switching, a pension scheme could potentially incur substantial transaction costs.[53]

(b) Mercer noted that switching to a new fiduciary manager is likely to take around 4 – 12 weeks to implement depending on the complexity of the scheme's arrangements.[54]

112. Several parties submitted that, given the nature of investment advice, IC and FM do not lend themselves to frequent switching.

(a) Mercer and LCP highlighted some benefits for clients of having a long-term relationship with their investment consultant and/or fiduciary manager. First, the adviser having a detailed knowledge of the background of the scheme is valuable to clients. Second, having a long-term perspective on the scheme's portfolio allows more tailored and consistent advice over time.[55]

(b) Regarding FM switching, Cardano highlighted that most of the fiduciary mandates are very recent, less than two years old, and thus there has not been much switching yet.[56]

Emerging findings on the switching process

113. The evidence reviewed so far indicates that the switching process is generally longer and more costly in FM than IC. Although this varies considerably on a client-by-client basis, estimates submitted by parties indicate that the FM switching process would usually take a number of months, with costs typically in the range of 0.1% to 0.5% of assets. In contrast, it is our understanding that the upfront timings and costs for switching IC provider are minimal.

114. We have not concluded at this stage whether FM switching costs are in any sense 'too high', or whether suitable remedies exist to reduce switching costs. We address the latter point in the following section, and welcome views on either of these two points.

115. We note however that the existence of potentially high switching costs in FM would highlight the importance of competition working well, and active trustee engagement, at the point when a scheme first moves into FM. This issue is

[53] Source: LCP's Issues Statement response.
[54] Source: Mercer's Issues Statement response.
[55] Source: Mercer's and LCP's Issues Statement responses.
[56] Source: Cardano's hearing summary.

analysed in more detail in our working paper on the supply of fiduciary management services by investment consultancy firms.

Potential remedies

116. In the event that we find an AEC, and that the level of trustee engagement is a feature that constitutes the AEC (or a part of it), we will consider the need for remedies. In this section we outline our emerging thinking on potential remedies.

117. Our issues statement and our working papers on information on fees and quality and the supply of fiduciary management services by investment consultancy firms identified potential remedies which may also have an impact on trustee engagement. In publishing those papers we have asked parties for views on those remedies. We are currently reviewing responses to those papers and do not include further detailed discussion of those remedies in this paper.

Our emerging thinking on potential remedies

118. We have identified three themes to potential remedies on which we intend to develop our thinking:

   (a) Measures to inform trustees of switching costs;

   (b) Measures to empower and incentivise trustees to engage ; and

   (c) Measures to reducing switching costs.

119. We discuss potential remedies within each of these three themes. These themes broadly align with the access – assess – act framework discussed in paragraph 20.

Figure 6: Designing remedies to support engagement

A

ACCESS - Do trustees receive the information they need?

- Remedies to provide good quality, timely information

A

ASSESS - Are trustees able to use the information they receive?

- Remedies to support trustees in assessing information
- Remedies to make sure information is viewed in context

A

ACT – Are trustees able to act to get the best service?

- Remedies to reduce the cost of and barriers to switching

Source: CMA

120. In developing our thinking on potential remedies to address trustee engagement we are conscious of recent and ongoing regulatory and industry-led developments. We further recognise that in the event of finding an AEC and examining remedies, we will need to consider how the remedies within a package of remedies would interact with each other. For example, remedies set out in our working paper on information on fees and performance could provide better quality, comparable information which on their own could drive engagement as measured by the four indicators set out above.

121. In the event that we find an AEC, and that the level of trustee engagement is a feature that constitutes the AEC (or a part of it), we will also reflect on whether measures designed to directly increase engagement, measured using our four indicators, drive meaningful engagement that in turn drives competition rather than just a tick-box approach to compliance. We cover our emerging thinking in our discussion of unintended consequences in paragraphs 133 to 137.

122. In the discussion that follows we identify in places our emerging thinking on potential approaches to implementation. Broadly we have identified that implementation could be through one or more of:

(a) A CMA Order to impose duties or requirements on firms, schemes or trustees. We would expect such an Order to be in place within six months of our final report (albeit with potential for a transitional period before it came into effect).

(b) A CMA recommendation to one or more of:

(iv) TPR – to amend either the Trustee Toolkit or Codes of Practice or introduce additional guidance

(v) DWP – to introduce primary or secondary legislation to effect change

(vi) FCA – to introduce rules on firms that are FCA-regulated. However, in the case of IC firms, not all activities are in scope of the FCA's regulation. There may therefore be potential for extending the FCA's scope of regulation.

(c) Undertakings offered by parties that would be a legally binding agreement to change behaviours or practices.

123. Subject to the nature of any potential remedy we might consider a combination of approaches, particularly where we believe action by a third party would be the most appropriate outcome but where timing of a third party's actions might be uncertain.

124. A phased approach would potentially allow changes to be introduced more quickly by CMA Order, whilst allowing those changes to be reflected in updated rules or guidance, which may require additional consultation or legislative reform. However, as this could introduce some uncertainty and additional cost if those affected have to implement two sets of changes, and we would ensure that there are not concurrent sources of regulation.[57]

Measures to better inform trustees of FM switching costs

125. In our review of client documentation and tender materials we have seen only limited evidence of firms providing details of FM service exit or switching costs either at the point of tender, or at any other stage of the relationship. We are therefore aiming to understand whether and how trustees should be provided with information on FM switching costs.

126. The provision of information on switching costs alone would not likely be sufficient to drive increased levels of engagement. Rather, when presented alongside other metrics, this information could help trustees choose an FM (or other) approach that best balances their goals and provides flexibility.

127. The potential remedies we are considering therefore could include both mandating the provision of information of costs on a timely basis but also information to provide appropriate context:

[57] A CMA Order might be made to address certain issues relatively quickly, in anticipation of further change. The Order could include provision to remove requirements as they are incorporated into law or regulation.

(a) **Obligations on firms to disclose FM service exit costs,** to help trustees better understand the cost of switching. Providing this information, either at the point of tendering or change in approach could allow trustees to factor in the impact of particular investment approaches or strategies on their ability to switch when making decisions (e.g. whether to move into FM).

(b) **Contextualising FM service exit costs.** Some elements of the cost of switching may be consistent or identical with the general costs of managing assets. The effectiveness of disclosing anticipated switching costs is likely to be enhanced or complemented by improving the disclosure of fees incurred by schemes from day-to-day investment decisions. Providing sufficient context might be through presenting exit costs relative to:

(i) Assets under management.

(ii) Consultancy and/or overall investment fees.

(iii) Return on investment.

(iv) Impact on member outcomes.

128. Any requirement to provide estimated exit costs would need careful consideration to ensure that firms were able to provide these in a comparable format and to a standard methodology. We have also considered the potential for switching costs to be benchmarked, though we are cautious of the feasibility of such an approach in allowing meaningful comparisons, particularly given the potential range of scope of mandates and different investment strategies.

Measures to drive trustee engagement

129. We have considered whether there are potential remedies which could directly trigger trustee engagement. We would welcome additional views on the following:

(a) **Guidance to trustees.** We anticipate that any additional or streamlined guidance would be best issued by TPR given their existing role. The impact on engagement will likely be determined by the nature of the guidance and the strength of any recommendations included. The scope of the guidance could be broad, from template and pro forma tender documentation (to reduce costs of tenders) through to factors for trustees to consider when deciding whether or not to conduct a tender process or the frequency. This could relate to both IC and FM.

(b) **Measures to improve governance standards.** This could include mandating the use of professional trustees, investment sub-committees and in-house investment advisors. The minimum requirements expected of lay trustees (eg around knowledge and understanding) could also be strengthened to introduce requirements to actively consider value for money of an incumbent or the sufficiency of any policy on testing the market. We also welcome views on the role of the scheme sponsor and possible measures for strengthening the sponsor's role, such as requiring greater responsibility for suggesting the need to test the market.[58]

(i) Our analysis so far indicates that levels of engagement are considerably lower than average amongst DC and small schemes. We welcome views as to why levels of engagement might be lower amongst these schemes and possible measures to increase the trustee engagement of such schemes in particular. Although some of the proposed governance measures may not be suitable for the very small schemes and those with few trustees and we also welcome views on this.

(c) **Enhanced obligations on trustees to obtain value-for-money.** An obligation on trustees could be formulated in a variety of ways to achieve greater levels of engagement than currently, whilst allowing trustees flexibility of approach. Measures might include strengthening the VfM requirements on DC schemes (e.g. by mandating explicit benchmarking of fees and performance), and/or extending such requirements to DB and hybrid schemes.

(d) **Mandatory tendering or switching.** Such measures would directly drive measures of engagement but would attract costs and may reduce choice or flexibility for trustees. Any requirement could be either on first adoption of a service (which is likely to be of greater relevance in FM) or periodically (for example, every five or ten years).

(e) **Trustee reporting to scheme members or TPR.** Trustees could be incentivised to conduct more frequent or formal market testing if they were required to report either to scheme members or TPR on their planned approach to appointing an investment consultant or FM provider and their proposed approach to testing the market.

[58] This would however need to be consistent with any existing trust-deed.

Measures to reduce FM switching costs

130. We wish to examine whether the cost of switching FM provider can be reduced. We have not at this point identified potential remedies to reduce switching costs directly. We would like to understand whether there are changes across the FM sector which could reduce switching costs and whether particular business models have higher switching costs.

131. At this point we do not take a view on whether switching costs are high or where they are more or less controllable. We would therefore like to understand better the following to inform the design of any potential remedies:

(a) **The structure of switching costs.** We understand that the management of a portfolio of assets potentially involves a large number of parties, particularly where there are a range of asset classes or assets are held in various funds. We would like to understand the extent to which any of these costs are avoidable or are controllable by FM providers.

(b) **Reducing costs in transferring assets.** As part of understanding what drives the costs of switching we would also like to understand better whether particular approaches to investment including ownership and custodianship of individual assets or particular asset classes can, *ex ante*, be expected to offer lower costs without affecting investment performance.

(c) **Implicit costs of switching.** We would expect that any FM provider winning a new engagement will incur the cost of staff time in developing their investment approach and potentially unwinding or transferring existing investments. Depending on fee structures this might be directly charged to a client or built into ongoing fees as part of an assessment of the likely lifetime value of a client. We would like to understand the scale of these costs relative to overall fees.

132. Aligned to developing our general understanding of the composition of switching costs as outlined above, we are keen to understand whether specific approaches adopted by different FM providers can lead to lower costs.

Unintended consequences

133. The potential remedies we have set out above and in other working papers could drive engagement as measures using our four indicators. However, we are keen that in the event that we find an AEC, and that the level of trustee engagement is a feature that constitutes the AEC (or a part of it), increased trustee engagement as a result of any potential remedy is meaningful.

134. We have identified the risk that imposing requirements on trustees directly or indirectly to conduct tender processes or switch will introduce additional cost. Where that trustee engagement is forced we are wary of the risk that trustees may feel as though they are simply 'going through the motions' to ensure compliance without expectation or realisation of any benefit. Our preferred approach in relation to engagement is that trustees are supported by access to sufficient information and resources to reduce the cost of testing the market. However, we will need to consider whether such measures on their own or in conjunction with a package of remedies would be effective and will address any potential AEC and/or resulting customer detriment that we may find.

135. In reaching any conclusion on a potential remedies package we will therefore reflect on the costs to trustees and schemes and the likely benefit that will accrue to schemes.

136. In relation to switching costs, our analysis indicates that there are relatively low levels of engagement for certain groups of clients (such as DC and small schemes). We are therefore very conscious that in potentially seeking to improve the visibility of exit or switching costs, there is a risk that trustees may either a) be discouraged from testing the market if the proposed costs appear high in absolute terms or b) focus excessively on switching costs rather than the possible improved returns from changing strategy.

137. In the event that we do seek to improve the quality of information on switching costs, we consider that this risk is likely to be addressed by ensuring that sufficient contextual information is made available.

Questions on potential remedies

138. In considering how any potential remedy or remedies would address any AEC and/or resulting customer detriment that we may find, we invite views from parties on any aspect of the discussion of potential remedies. We set out below three groups of questions that we are particularly keen to receive views on.

Questions on potential remedies

1) **How can switching costs be reduced?**
    a) Are there measures which trustees or FM providers could implement which would reduce the costs of switching providers? For example, the structure of contracts or the ownership of underlying assets.
    b) How do switching costs vary by the type of FM service provided, and where specifically are costs incurred?

2) **Can FM providers present better information on switching and exit costs in advance?**
   a) What are the challenges for FM providers in providing accurate exit or switching costs in advance, e.g. when tendering?
   b) What are the key drivers of the cost of switching and should these be disclosed separately?
   c) How could anticipated switching costs be presented to trustees in a meaningful way, for example relative to other drivers such as asset base, net or gross returns or annual fees and charges?
   d) What would a meaningful benchmark for switching costs be?
   e) Could the provision of information on switching costs to trustees discourage tendering or switching?

3) **Potential remedies in other working papers and ongoing developments**
   a) Would any of the remedies included in other working papers be an effective and proportionate way of driving engagement either individually or collectively?
   b) Could any amendments be made those potential remedies to more effectively drive trustee engagement?
   c) Could any recent, ongoing or anticipated regulatory or other developments in the IC or FM sectors affect current levels of trustee engagement?

Annex 1: TPR codes of practice and guidance

139. In this Annex we cover TPR's codes of practice and related guidance and initiatives, that assist trustees in fulfilling their regulatory requirements and managing their scheme effectively. We focus in particular on code of practice 7, as this relates specifically to 'trustee knowledge and understanding'.

Codes of practice

140. TPR has produced 14 codes of practice, which provide practical guidelines on how to comply with the legal requirements of pension regulation.[59] In this sub-section we highlight particular aspects of the codes of practice which directly relate to trustee engagement.

Code of practice 7 – trustee knowledge and understanding

141. Code of practice 7 recognises that the level of knowledge and understanding required of a trustee will vary depending on the type of scheme, their role and their level of expertise. Trustees may take into account, for example, the size and maturity of the scheme and whether there is an investment sub-committee.

142. To ensure that every trustee acquires the required level of knowledge and understanding, TPR has developed the trustee toolkit. Code of practice 7 states that 'the regulator is of the view that this is required learning unless [trustees] can find an alternative learning programme which covers all the items in the scope guidance at a level relevant for them and within the timescale allowed'. It is 'strongly' recommended that trustees review their knowledge and understanding at least annually.

143. Regarding professional trustees, the code of practice states that they should be appropriately qualified to fulfil their role, and be fully conversant with scheme documents, from the date of appointment onwards. (Non-professional trustees have a period of six months to do so from the date of their appointment.) It is also stated that 'experience will clearly be required [for professional trustees] and it is likely that a formal qualification will be expected'.

[59] TPR notes (e.g. COP 7, p.4) that 'codes of practice are not statements of the law and there is no penalty for failing to comply with them. Nevertheless, codes have legal effect; they must be taken into account by the regulator, a court or tribunal, if they are relevant to what is being decided'.

Other codes of practice

144. Code of practice 3 ('funding defined benefits') states that 'trustees should have sufficient and appropriate knowledge and understanding to enable them to provide sound and prudent oversight of the investment strategy. This may require having investment and/or risk management expertise within the trustee board in order to critically evaluate and oversee the investment strategy and associated risks, particularly where more complex investment strategies or risks are undertaken'.

145. Code of practice 13 ('the DC code') states that the trustee board should have sufficient breadth of knowledge and understanding to 'fully understand any advice they receive' and to be able to 'challenge advice they are given'. Trustees are also expected to 'regularly monitor the performance of their service providers'.

TPR guidance

146. TPR has produced a series of guidance documents to help trustees comply with their legal requirements (several guides directly accompany the codes of practice). Here we highlight particular extracts that directly relate to trustee's engagement with their advisors and/or their levels of knowledge and understanding.

147. In the guidance on 'relations with advisors', TPR recommends that trustees should 'regularly assess whether the advisor is good value for money'. Trustees should also ensure that they have a clear understanding of the fees being charged; this includes understanding how and when fees may be increased, and assessing the reliability of advisors' cost estimates.

148. In the guidance on 'scheme management skills' (accompanying code of practice 13), it states that DC scheme trustees should assess advisors' and service providers' performance 'against documented targets, measures and/or objectives on a regular basis'. It also notes that 'monitoring the performance of advisors and service providers is a core element of the legal requirement on many trustee boards to assess annually the value for members provided by their scheme'.

149. In 'DB investment guidance' (accompanying code of practice 3) it is recommended that trustees 'should commit sufficient time and resources to the process of selecting and appointing a fiduciary manager. This includes taking appropriate advice and considering a suitably wide range of potential managers, as for any other investment management appointment'. It is also suggested that trustees may wish to appoint an independent third party to

advise on the selection of a fiduciary manager, and the ongoing monitoring and evaluation of their performance.

21st Century Trusteeship

150. TPR's 21st Century Trusteeship campaign is a targeted communications campaign to clarify the regulator's expectations of the actions that trustees should take to meet their requirements and to manage their scheme effectively. Trustees are prompted to assess their governance across a core list of standards, and are signposted to new and existing resources to help them do so.

151. Within the documentation, trustees are advised to annually assess their knowledge, understanding and skills, and evaluate the decisions they have made over the past year. It is also suggested that scheme Chairs conduct individual performance appraisals and ensure that there is an annual evaluation of the board's overall effectiveness.

Annex 2: Levels of engagement – regression analysis

152. Table 6 presents the results of five separate regressions considering the factors that potentially influence whether a scheme (i) switched, (ii) switched or tendered, (iii) conducted an internal review of fees and/or quality, (iv) conducted an external review of fees and/or quality, or (v) undertook any of these actions. The data is based on the CMA survey.

Table 6: Levels of engagement – IC services

	(1) *Switched*	(2) *Switched and/or tendered*	(3) *Internal review*	(4) *External review*	(5) *Any of these actions*
DB	-0.03	-0.08	-0.00	-0.03	-0.02
DC	-0.13**	-0.18**	-0.09	-0.10**	-0.08
Small	0.06	0.01	-0.08*	0.02	-0.04
Large	0.10**	0.05	0.04	0.02	0.08**
Inv_SubCommittee	-0.08**	-0.07	0.08*	-0.01	0.06
Big 3	-0.19***	-0.14***	-0.05	-0.01	-0.11***
Between 3-5 services	0.01	0.02	0.07	0.06*	0.05
Between 6-7 services	0.04	0.06	0.16**	0.10**	0.10
Actuarial services	-0.02	-0.04	0.03	-0.01	0.04
FM Services	0.11**	0.12**	0.02	0.10**	0.04
Scheme administration	-0.07*	-0.03	-0.06	-0.05	-0.06
Constant	0.34***	0.51***	0.55***	0.12**	0.69***
Observations	783	783	783	783	783
R-squared	0.07	0.04	0.05	0.03	0.05

*** p<0.01, ** p<0.05, * p<0.1
Standard errors are omitted for brevity. Omitted categories are hybrid, medium, no investment subcommittee, fewer than 3 services, no additional (non-IC) services.

Annex 3: The FM switching process and costs

153. In this Annex we detail the process and costs for switching between FM providers. As noted in the main text, switching FM provider typically involves a considerable upfront revision to the client's investment strategy; this generally requires assets to be moved from one set of funds to another. Due to this revision, and the potentially costly transfer of assets, the switching process usually involves both a planning phase and an implementation phase.

154. We cover these two phases in turn.

Planning phase

155. There are several aspects of the planning phase, many of which can occur concurrently. Key amongst these are strategic planning, legal reviews and transition planning.

156. The overall timings involved in this phase depend on the complexity of the scheme's investment strategy, the level of negotiation required between the trustees and the provider, and the frequency of trustee board meetings. Responses from parties indicate that this process can take anywhere from a week to several months.

Strategic planning

157. The trustees and the destination provider need to agree suitable investment objectives and any constraints that will be placed on the provider. Based on this, an investment strategy will be developed which will determine the structure of the proposed investment portfolio. This will be underpinned by detailed statistical analysis, including the modelling of asset and liability movements under different scenarios.

158. These overarching investment objectives, guidelines and strategy will be incorporated into the investment management agreement (IMA), which is the contract between the client and the provider.

Administration and legal reviews

159. There are a number of administrative tasks that need to completed, including tax documentation and anti-money laundering ('know your client') checks. Most importantly, the client and provider need to agree upon the IMA – i.e. the underlying contract. This will involve a period of negotiation and review by legal advisors.

(a) We have limited visibility into approximate legal costs, and they will vary on a client-by-client basis. Aon has submitted however that they have negotiated special rates with a number of law firms that have experience with their documentation.[60] They will provide legal reviews of the IMA at a [✄].

160. Depending on the arrangements of the destination provider, some schemes will be required to appoint a custodian, and those with an incumbent custodian will be required to complete relevant documentation. Particularly if a new custodian is required, this could take several weeks.

Transition planning

161. The destination provider will need to collect details from the trustees on the current investment arrangements of the scheme, including detailed account information and portfolio holdings. Based on this information, the provider will devise a transition strategy to reallocate the client's assets into the new portfolio (agreed as part of the strategic planning).

162. The provider will assess, for example, whether current investments need to be redeemed for cash, or whether some of them can be transferred directly ('in specie'). Some funds, such as private market funds or property, may have 'lock-in' periods, which prevent the client from withdrawing assets without heavy penalties.

Implementation phase

163. The implementation phase is the process of transferring the client's assets into the new portfolio. As noted by a number of providers, the timing and costs involved vary considerably on a case-by-case basis and depend, in particular, on the complexity and liquidity of the client's current portfolio.

The transition process and timings

164. The time taken to transition assets from one portfolio to another varies considerably on a case-by-case basis. Overall timings are particularly affected by:

(a) The client's current portfolio. If a client is invested in highly illiquid assets (such as private market funds or infrastructure), there may be significant exit charges and lock-in periods. It may be cost effective to transfer such

[60] Source: Aon's submissions to the CMA.

assets gradually, or in some cases to keep the assets in the current investment until the fund is wound down.

(b) The process for redemption and investment. In some cases, clients may be able to transfer assets directly ('in-specie') between providers. In other cases, existing assets must be sold for cash before being re-invested in new funds.[61] If assets can be transferred directly, this can occur within a matter of days. Disinvesting (for cash) and reinvesting in new funds can be on a timescale of weeks or months.

(c) Frequency of trading. If funds are traded daily, then assets can be redeemed from a fund within a few working days. Some funds only allow quarterly redemptions however, whilst some require several months' notice.

165. It is therefore difficult to generalise about the length of time taken to transfer assets from one portfolio to another. Cardano for example submitted that the transition process could take between a number of days and a number of months; they stated that this depends on the liquidity of the initial portfolio and specific redemption terms. River & Mercantile submitted that the bulk of assets could be transferred within two – six weeks, but less liquid assets could take longer. Russell Investments submitted that it takes between five and 90 days to disinvest from the portfolio held by the previous FM provider and five - 30 days to invest in the Russell Investments arrangements.

166. Each of the major FM providers have in-house teams to oversee or assist with the process of transitioning assets from the current portfolio to the targeted portfolio. The cost of this service is typically incorporated into the overall FM fee, although in some cases clients may be charged extra for particularly complex transitions.

167. Alternatively, schemes can appoint an external 'transition manager'. This is most likely to be done when the portfolio is particularly complex, and there are potential risks and/or costs that can arise during the transition. As an indication of the cost of an external transition manager, Aon has negotiated rates of [✄] with [✄]. This implies a cost of £[✄] for a client transferring £100 million of assets.

[61] As an example, Aon's FM solution for clients with assets below £30 million is to invest in 'fruition funds'; clients have a choice of investing in 5 pooled funds. Investment in these 'fruition funds' must be made as cash. Clients must disinvest from their existing holdings before subscribing to these funds.

Transaction costs

168. In the absence of entry and exit charges applied to investment funds (discussed below), the main costs involved in transferring assets are 'transaction costs' which are ultimately paid to the banks and brokers that trade the securities.

169. Transaction costs vary considerably by asset class. BlackRock has provided the following estimates of transaction costs for a number of major asset classes, including both the 'sell cost' and 'buy cost'. A scheme switching from one portfolio to another would typically be required to pay both of these transaction costs. These costs are not specific to BlackRock products but are based on typical pooled fund spreads observed in the market and exclude any transition management fees.

Table 7: Typical transaction costs by asset class

Asset class	*Sell cost (%)*	*Buy cost (%)*
Equities		
UK equities	0.05 – 0.10	0.55 – 0.60
International developed equities	0.10 – 0.20	0.10 – 0.20
Emerging market equities	0.30 – 0.40	0.30 – 0.40
Bonds		
Government bonds	0.02 – 0.05	0.02 – 0.05
Corporate bonds	0.20 – 0.60	0.20 – 0.60

Source: BlackRock. The above costs are as a % of assets traded. The costs are not specific to BlackRock products but they are estimated and based on typical passive pooled fund spreads observed in the markets.

170. A scheme's total transaction costs will therefore depend on the mix of asset classes in its current and proposed portfolios. Further, these costs may be significantly lower in cases where assets can be transferred 'in specie'.

171. A number of providers have submitted estimates of the overall transaction costs that might be incurred by pension schemes switching from one provider to another:

(a) Mercer submitted that the transaction costs incurred when disinvesting from Mercer funds for a scheme with 50% in growth assets would typically not be more than [✄]% of assets. They noted that a client might incur similar costs if reinvesting the assets with another FM provider. This implies that overall transaction costs (based on an upper bound of 0.5% of assets) could be around £500,000 for a pension scheme with assets of £100 million.

(b) WTW submitted that based on their experience, average transaction costs were around 0.25% of assets for clients with assets below £1 billion. This falls to 0.1% for those with assets above £1 billion. For a pension scheme with assets of £100 million, this would imply total transaction costs of around £250,000.

(c) Goldman Sachs submitted that depending on the proportion of total assets that are 'rebalanced' and their structure, transition costs could be below 0.25% of total assets. This could rise to up to 0.5-1% of total assets. If costs were to reach 1%, this would amount to £1 million for a pension scheme with assets of £100 million.

(d) Schroders submitted that typical transaction costs of investing for a new client would be equivalent up to 0.08% of assets. This would imply total transaction cost of around £80,000 for a pension scheme with assets of £100 million. If a Schroder's existing client redeems assets to another provider, the typical transaction cost would be equivalent to 0.07% of assets. This would imply total transaction costs of around £70,000 for a pension scheme with assets of £100 million.

(e) River & Mercantile submitted 3 case studies in which a client switched into their FM service from another provider. Although they were only able to provide approximations, transaction costs were in the range of 0.1% to 0.3% of assets.

172. To put these figures in context, we note that the Ernst & Young FM Fees Survey 2017 estimates a median FM fee (excluding investment management costs) of around 0.2-0.3% of assets per year, and overall fees (including investment management costs) of around 0.5 - 0.7% per year (for clients below £250 million).

173. Depending heavily on the complexity of the initial portfolio, transaction costs in some cases could therefore represent approximately a year's worth of FM fees.

Entry and exit charges

174. Apart from transaction costs, it is our understanding that most funds do not incur explicit entry or exit charges. The main exceptions to this are highly illiquid asset classes such as private markets, infrastructure and property. Investments in these asset classes may also be subject to lock-in periods, potentially lasting many years. As noted above however, such investments would not typically affect the switching process as they could be retained until the fund winds down.

175. Some funds may apply ‘anti-dilution levies’. The aim of these levies is to protect remaining investors from fluctuations in the value of their holdings due to the exit of an investor. Such levies are therefore more likely to apply to larger investments, which may complicate the exit of particular funds.

(a) SEI Investments for example submitted that disinvestment from its manager of manager funds may be subject to a redemption fee if the redemption amount from any particular fund represent more than 5% of the total assets of the fund; this is designed to protect other shareholders from the transaction costs associated with large redemptions.

Variation across clients

176. The overall switching process and timelines appear to be broadly similar for DC and DB schemes. There is an additional complication in the case of DC however in that individual members’ investments are likely to be impacted by the change, which will require communication with members and records to be updated. As noted by Aon, ‘the extent and type of communication will impact the expected timescales’. River & Mercantile also note that individual members continue to contribute to their DC ‘pot’ during the transition process, and therefore a ‘blackout window’ may need to be put in place.

177. Parties indicated that there is no substantial difference between switching FM providers and moving into FM for the first time. Similarly, there appears to be no fundamental difference between the switching processes for full and partial FM. In practice, switching may be quicker in the case of partial FM as clients will not typically need to undertake the detailed strategic planning phase.