



# INVESTMENT CONSULTANCY SERVICES AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

AON RESPONSE TO CMA WORKING PAPER: TRUSTEE  
ENGAGEMENT

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## **CMA WORKING PAPER ON TRUSTEE ENGAGEMENT**

### **RESPONSE FROM AON**

#### **INTRODUCTION AND SUMMARY**

Aon welcomes the opportunity to respond to the CMA's Working Paper on trustee engagement dated 12 April 2018 (the "**WP**") which has been released in the context of the CMA's wider work on assessing Theory of Harm 1. In the response below we also refer to the Trustee Survey results that were published by the CMA on 29 March 2018 (the "**Trustee Survey**"). In summary:

We recognise that it is essential for the interests of pension scheme members that trustees are fully engaged purchasers who can properly assess the options for IC and FM services and who can readily switch providers to obtain high levels of service and value for money if and when this is appropriate.

Our experience is that we operate in a highly competitive market. This is driven by trustees holding us to account, by corporate sponsors, professional trustees and third party evaluators complementing the skills of lay trustees by evaluating and providing challenge to our services, and by clients tendering and switching providers.

However, it would be wrong for the CMA to conclude that its findings in this WP, namely that levels of engagement vary across pension schemes, and that switching costs are higher in FM than in IC, are signals of a market not working effectively.

- There are a number of objective reasons for the trends that the CMA has observed which do not relate to any deficit in competition, but instead reflect the differentiated nature of pension schemes and the inherent differences between IC and FM services;
- The CMA has misunderstood the iterative nature of developing advice in a client-consultant relationship over a period of time and the challenge that this brings.
- The switching process itself is not an impediment to switching taking place and this is supported by the outcome of the Trustee Survey, which identified that 82% of trustees found it easy to switch.
- The costs involved in switching an IC or FM provider will be similar on a like-for-like basis. The distinction is that the costs of changing IC provider are incurred over time, but immediately in FM. Costs are not driven by the switch itself but by the nature and extent of any strategy change;
- In any event, there is no evidence that the activities of IC or FM firms have made switching more difficult – it is inherent in making complex, high-value investments that a certain process will need to be followed to switch.
- The CMA has not fully analysed the factors that influence trustees to either switch or not switch.

Although we see no basis for the finding of an AEC with respect to Theory of Harm 1, we welcome initiatives to encourage trustee engagement. Such measures should have at their core the improvement of trustee skills and measures to incentivise trustees to act in a manner that is focussed on guarding members' interests.

At the same time, we recognise that pension trustees are already very heavily regulated. Careful thought should be given to the design of any additional obligations imposed on them. A workable system must ensure trustee compliance costs remain at a reasonable level.

## 1 TRUSTEE ENGAGEMENT METRICS

- 1.1 In our response to the CMA's Statement of Issues, we submitted that:
- 1.1.1 Whilst the trustee and pension schemes landscape is differentiated, the trustees we work with are, on the whole, highly educated and experienced and show high levels of financial literacy.
  - 1.1.2 Our experience is that trustees monitor and review the services we provide to them. There is a constant threat of switching. Where trustees do not consider they are getting the best advice and service, they run tender processes and switch. Low barriers to switching mean trustees can change provider, or multi-source, with relative ease.
  - 1.1.3 That said, we acknowledge that improvements can be made across the industry to support trustees in reviewing and appointing providers of IC and FM Services.
- 1.2 The evidence identified by the CMA in the WP supports our previous submissions.
- 1.3 In particular, the statistics cited at WP paras 40 and 41 show that trustees are experienced and well-educated and are able to make well-informed decisions. If the other CMA findings are also considered, it is clear that trustees have good levels of information available to them to take decisions with respect to their IC or FM provider, and for the most part, they have the necessary skill-set to use this information effectively. This accords with our experience – we operate in a market with significant competitive pressures as a result of the demands of our clients.
- 1.4 However, we note that the CMA has identified variable levels of engagement across the wider trustee population, with lower levels of engagement by smaller schemes and DC schemes, and that measures of engagement are lower in FM than in IC. We comment on these findings below.
- There are objective reasons for the variances in engagement that the CMA has identified
- 1.5 We do not find it unexpected that the CMA has found differing levels of engagement across the metrics that the CMA has measured, in particular that across the indicators, the evidence points to larger schemes being more engaged than smaller ones, or that trustees of DC schemes are less engaged. However, in our view levels of DC engagement may not necessarily be as low as the CMA indicates at Table 3. Our 2013 DC survey indicates that DC trustees spend on average 1-3 days per quarter on DC matters, which is not insubstantial.<sup>1</sup>
- 1.6 Clearly the differentiation in schemes will naturally lead to variation in the nature of engagement by trustees:
- 1.6.1 the nature of DC is that there is no obligation on the scheme sponsor to cover unfunded liabilities, as is the case with a DB scheme. As a result a

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<sup>1</sup> Available at: <http://www.aon.com/unitedkingdom/retirement-investment/defined-contribution/aon-defined-contribution-scheme-survey-2017.jsp>

- DC scheme sponsor may have less incentive to actively engage with the trustees in reviewing or switching its IC and/or FM provider;
- 1.6.2 automatic enrolment reforms mean that every UK employer is now required to make pension provision available to staff, which will all be DC schemes. Where companies are *obliged* to sponsor a scheme, it is inevitable that some will be less engaged.
  - 1.6.3 DC schemes can have lower apparent levels of switching than DB schemes for a number of reasons: many DC investments are fairly new so for some it may be premature to engage in switching or tendering considerations. DC also tends to be more focussed on low-risk, low-volatility passive investments for which switching can incur costs disproportionate to gains as a result of moving from one passive asset to another;
  - 1.6.4 it is not surprising that many DC schemes do not appear to regularly monitor member outcomes. Monitoring incurs cost, which may not comprise good value for money for smaller schemes. In addition, unlike DB schemes, even if trustees did undertake monitoring and, for example, identified a need for further contributions to achieve 'best outcome' for their members, they could not compel a scheme sponsor to contribute in any event.
  - 1.6.5 larger schemes tend to have a bigger exposure to risk if investments go wrong and a bigger potential for gains where they are successful. This incentivises trustees to engage more and so larger schemes will be better resourced than smaller schemes and have the ability and financial resources to seek professional help;
  - 1.6.6 the level of engagement of trustees is proportionate to the level of assets within the relevant scheme. It is logical that a bigger scheme, in respect of which the IC and/or FM provider will have a greater impact, will be more actively engaged;
  - 1.6.7 smaller organisations will tend to use DC, meaning that the lack of incentive and cost impact of engagement outlined above may be conflated;
  - 1.6.8 different schemes have different objectives when using IC and FM providers - Figures 4 and 5 of the WP indicate that trustees have a range of reasons for using IC and FM with increases in investment returns only being important for 49% of trustees purchasing IC and 51% of trustees purchasing FM. Such differing objectives will naturally lead to variable incentives to engage in the forms of switching and reviews.
- 1.7 The CMA observes that switching rates are lower in FM than IC. However, we would caution the CMA against using switching rates as an indication of trustee engagement within FM:

- 1.7.1 The FM market is relatively new and not yet sufficiently matured for switching practices to have fully developed. This cannot be overcome by simply removing clients that have received FM services for less than five years from the FM switching data set. FMs are appointed with long term objectives which stretch beyond a five year period. As such the adjusted data set would still contain a large proportion of clients which have not been receiving FM services for a sufficient length of time to be highly engaged in switching and reviews;
- 1.7.2 It is important to note that engagement in the context of FM provision will be different to 'engagement' with IC because the very nature of FM is to appeal to trustees who prefer to appoint skilled investment professionals to be engaged in their investments on their behalf. Trustees will also be aware that the benefits of FM can increase over time, as their appointed FM firm develops an increased understanding of their investment portfolio and their investment objectives; and
- 1.7.3 Trustees in any event show high levels of engagement in the initial decision to move to FM. 70% of schemes purchasing FM services for the first time (and who were able to remember the purchase) ran a tender process<sup>2</sup> and 62% sought advice from a third party or asked third parties to run a tender process before appointing their initial FM provider<sup>3</sup>. At the very least, the steps required when transitioning to FM takes time to complete, which requires active engagement on the part of trustees. Given the increased engagement in the initial selection process, it would not be surprising for engagement to reduce thereafter.
- 1.8 In light of these differences, a 'one size fits all' approach cannot be mandated to enhance trustee engagement.
- 1.9 To the extent that the CMA considers that an AEC is found and trustee-focused remedies are needed, a more nuanced approach is required in order to support the varying needs of schemes, to provide practical support to encourage engagement and to avoid burdening schemes with excessive cost and regulation. We comment in more detail on this in the section on remedies below.

Evidence of trustees' failure to challenge IC or FM firms is inconclusive

- 1.10 The CMA has not identified consistent evidence of a failure by trustees to challenge their IC or FM advisors, with 70% of respondents having asked their consultants to improve their terms in the last 3 years. The reason the figure is so much lower for FM is likely to be because many FM appointments have been in place for less than 2 years. This has the natural consequence that fewer trustees will have challenged their FM provider near the start of their term.
- 1.11 Paragraph 68 of the WP highlights the Leeds University Business School finding that 76% of trustees "*do not often reject the recommendations of their IC.*" as well

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<sup>2</sup> Trustee Survey, 5.18

<sup>3</sup> Trustee Survey, 5.6

as referencing findings in the tPR's Trustee Landscape survey with regards to low levels of disagreement with the IC recommendations.

- 1.12 This inference that trustees rarely challenge their IC appears to presuppose that the delivery of IC advice is a 'one shot' process. However, in reality the IC consultant will have spent a period getting to know the trustees, their investment objectives and their preferences. In meetings with the trustees, consultants will suggest potential investment strategies which are then discussed as part of an iterative process. By the time formal investment recommendations are made, clients would be expected to accept these, as they will have been tailored for approval and based on discussion.
- 1.13 This iterative relationship is likely to be a key factor that lies behind the CMA finding at para 72 of the WP that 64% of trustees surveyed said that they found it 'very easy' to monitor performance of their schemes and that a further 30% found it 'fairly easy'. This very much reflects our experience of dealing with astute trustees who understand our advice and have a dialogue with us as we develop it and implement their investment strategies.

Professional trustees play a significant and effective role

- 1.14 The results of the Trustee Survey, summarised at paras 34-37 of the WP, show whilst a number of trustee boards are made up of 3 trustees or fewer, a sizeable number of schemes use professional/corporate trustees and investment sub-committees. However, this data is only a snapshot and underlying trends are also important. In particular, while the CMA finds that 52% of schemes currently use a professional trustee, as the CMA acknowledges being told at para 36, this figure is increasing year-on-year.
- 1.15 We think it is particularly notable that the Trustee Survey indicates (WP para 40) that professional trustees sit on, on average, 16 trustee boards. This means that each professional trustee will have broad experience of the market, working with a variety of IC and FM providers. If this is combined with the fact that 52% of trustee boards contain a professional trustee, the clear majority of the larger schemes with whom Aon works have very well-informed trustees who are aware of the different IC and FM providers available to them across the market and place constant pressure on us to deliver a value for money service.

Other professional advisors are available to support trustee decision making

- 1.16 The evidence collated by the CMA as part of the Trustee Survey (paras 77-87 of the WP) confirms points we have made previously (in our presentation during the site visit, and in our response to the WP on the provision of FM by IC firms) that many trustees are well-advised by a broad range of professionals, who help them to make informed investment decisions, arm them to challenge the advice of their IC or FM provider, and to avoid being 'steered' into taking any service that does not suite their wishes or their needs. In particular we note that:
- 1.16.1 Scheme sponsors provide a useful additional perspective (49% of trustees say they are 'very important'). Advisors appointed by scheme sponsors in

particular provide a useful 'over shoulder' role to drive higher performance from the trustees' advisors.

1.16.2 Around 70% of trustees regard their scheme actuary as 'very important' or 'fairly important'. This matches our experience of being frequently challenged by actuaries and being required to take their views into account in devising investment strategies.

1.16.3 According to KPMG, 80% of new FM appointments were made following TPE involvement in 2017. This statistic strongly undermines any arguments that could be made that trustees are 'steered' into choosing an FM service offered by their existing IC services provider, even where that is against their best interests. Thanks to this expanded role of TPEs, we consider that, for the main part, trustees are well aware of the different FM service options available to them. The involvement of these third parties contributes to the competitive market environment in which we operate.

## 2. SWITCHING

### The switching process is not regarded in itself as an impediment to switching taking place

2.1 The Trustee Survey evidence cited by the CMA at para 96 of the WP accords with our experiences that switching need not be expensive or time-consuming. The number of trustees who said it was easy to switch IC are also high – 47% said it was 'very easy' and a further 35% found it 'fairly easy'.

2.2 The CMA has also not identified consistent evidence that switching is difficult with respect to FM (WP paras 98-101). The CMA merely indicates that "*both the overall timings and monetary costs of switching vary considerably on a client-by-client basis*" and notes that this is driven by the type of assets held in the initial portfolio and the extent of overlap between the initial and the proposed portfolio.

2.3 These drivers point towards the nature of any consequent strategy change being the key determinant of the cost of switching rather than the switching process itself. These costs ultimately derive not from the IC or FM provider, but from the underlying asset management fees, in particular the level of the underlying transaction costs, which the IC/FM passes on to clients. As such, there is no evidence that the process of switching has the ability to contribute to the finding of an AEC.

2.4 We appreciate that the CMA has not reached conclusions as to whether switching costs are 'too high' but think it important to note that we see switching costs in themselves as reasonable and proportionate.

### The overall time and cost involved in switching is linked to any consequent strategy change

2.5 The CMA states that evidence indicates the switching process is generally longer and more costly in FM compared to IC. This is an oversimplified view. Clients tend



to switch their IC or FM providers in order to achieve better outcomes, which will ordinarily require some form of strategy change. An assessment of the cost and time impact of switching must focus on all aspects of any transition into a new strategy.

- 2.6 Within FM, a strategy change will be effected rapidly upon switching to a new provider. This accounts, to an extent, for the time involved in switching to a new FM provider as the strategy change will be discussed and agreed in advance. It also helps to explain any potential perception that costs involved in switching FM provider are higher, because all the costs associated with the strategy change are incurred up front.
- 2.7 In contrast, whilst the switch to a new IC provider can be relatively swift, the resultant strategy change is more likely to be implemented gradually over a period of time. This means that costs involved in implementing the strategy changes are less evident at the outset.
- 2.8 Whilst the CMA has built the time and cost implications of strategy changes into its analysis of FM switching, it has not done so for IC. This means that comparisons between the two are not made on an equivalent basis. In our experience, the costs involved in switching an IC or FM provider will in fact be similar on a like for like basis. The key difference is the period over which those costs are incurred.

There is no evidence to suggest that switching has been made difficult

- 2.9 The CMA has not assembled evidence that the activities of IC or FM firms are making it artificially difficult for trustees to switch. This confirms Aon's experience and our practice.
- 2.10 While we always strive to make switching as easy as possible, trustees are making complex, high-value investments. This means that a proper sequence of steps must be taken to preserve the value of those investments in the event of switching.

The nature of the investments for which trustees are responsible do not favour very regular switching

- 2.11 We agree with the points noted by the CMA at para 112 of the WP that the nature of investments on which IC or FM firms advise mean that long-term relationships bring benefits to clients. There is a need to avoid incurring certain unavoidable costs of switching too frequently. This kind of 'churn' is generally frowned upon by the Financial Conduct Authority in the context of investments, a rationale that would equally be applicable in relation to IC and FM services. In addition, long term relationships allow advisors to build up a detailed knowledge of their clients' schemes. This long-term perspective leads to more tailored and consistent advice.

Switching from IC to an FM provider does not necessarily involve a change of strategy

- 2.12 The CMA appears to have over-simplified certain aspects of switching, in particular, when schemes switch from IC to FM for the first time. As we set out in our response dated 6 March 2018 to the CMA's questions on FM switching, while more often than

not a switch of advisor and a change of strategy will take place at the same time, they should be considered separately.

2.13 For example, we explained to the CMA in para 2.5 of Aon's response to the Statement of Issues and also at paras 1.3 to 1.4 of Aon's response to the WP on the provision of FM by ICs, that trustees often choose FM where, for practical reasons, they wish to have access to an implementation service even though they are content with the investment strategy being advised by their IC.

2.14 By assuming that there will always be a change of investment strategy, this can lead to the incorrect assumption that an initial switch from IC to FM is an expensive, involved decision and that if a trustee appoints their existing IC as their FM that they have been 'steered' into this and side-stepped that process. As we explained in our response to the WP on the provision of FM by IC firms, the reality is that clients often have a more simple decision to take of whether to purchase investment implementation, for which they have ample information to take an informed decision.

Cost is not the only consideration when switching

2.15 Trustees are legally required to make sure that any decision to switch is taken in the interests of members. This will involve carrying out a cost benefit analysis of which the fees of effecting the switch is only one element. Focussing solely on fees as a determining factor for switching therefore fails to consider the broader context in which trustees operate and make decisions when purchasing IC and FM services.

There is no analysis in the WP or the Trustee Survey on the factors that influence trustees to make the decision to switch or not to switch

2.16 As set out at paras 2.6-2.13 of our response to the WP on the provision of FM by IC firms, the Trustee Survey, while indicating the reasons why a trustee might prefer IC or FM, does not analyse the reasons why trustees choose to switch or not switch. This is a fundamental omission in the CMA's analysis in this investigation.

2.17 The decisions taken by trustees are complex and nuanced and it is not appropriate to assume simply that a switch would be in a scheme's best interests on every occasion, or that a low-level of switching demonstrates weak competition.

2.18 In many instances, trustees will have already undertaken due diligence on their IC firm's strategy, operational due diligence capability and manager selection expertise. Since these are core criteria in choosing an FM just as they will have been when the scheme chose their IC provider, so long as they are content with their existing IC's strategy, it is natural for many trustees to conclude that their existing IC provider would be their best fit to provide FM.

Emerging findings on switching – insufficient to show an AEC

2.19 We recognise that the ability to switch providers is important for customers to achieve best value and for competition to work effectively. However, 82% of trustees have told the CMA that they find it easy to switch IC and 57% of trustees

could not identify any measures which could make switching IC easier. No survey findings are adduced as to trustees' experience of switching FM provider.

- 2.20 As such, the evidence that the CMA has collated on trustee switching is insufficient to support a finding that there is an AEC with respect to Theory of Harm 1.
- 2.21 To the extent that there is any complexity in switching, this is largely due to the nature of the products themselves and the impact of implementing strategy changes, rather than any impediments created by either the approach of the trustees, or of IC or FM firms.
- 2.22 However, we support additional measures that could be taken to provide sufficient information to inform trustees and to help them navigate this process as effectively as possible and comment further on these in section 3 below.

### **3. REMEDIES**

- 3.1 Although we see no basis for the finding of an AEC with respect to Theory of Harm 1, we welcome any initiative to encourage trustee engagement, which should ultimately help to ensure that trustees are responsible for operating their schemes in a manner that is sufficiently focussed on guarding members' interests.
- 3.2 We strongly support the current measures that the tPR is taking and encourage it to be an effective regulator in this regard. Having the tPR already in place provides the opportunity to address readily any issues with trustee engagement and the CMA should fully explore what actions tPR can take before introducing any additional measures.
- 3.3 In particular, we would encourage the CMA to work with tPR to develop remedies that would better incentivise trustee and sponsor engagement across all pension schemes, as this will ultimately have the most impact on behaviour. This will be particularly important in respect of DC schemes where, compared to DB, there may be less of an incentive for the sponsor to encourage active engagement. tPR already routinely produces guidance, although the impact of this is dependent on what powers of enforcement tPR is given.
- 3.4 We endorse the CMA's comments at paras 133-137 of the WP that it is necessary to be conscious of unintended consequences of remedies, to the extent that they are imposed. We would particularly amplify that trustees are already subject to considerable administrative obligations. The introduction of any sub-optimal measures to require trustees to test the market, conduct tender exercises or even compulsorily switch IC/FM provider would risk adding additional cost and complexity to the trustee role without achieving what should be the CMA's core objective, of securing better outcomes for scheme members.

#### Measures to better inform trustees of switching costs

- 3.5 We agree that there could be scope to standardise a degree of information on costs and switching mechanics to streamline processes for trustees.

- 3.6 A DB Chair's statement is already on track to be introduced (announced in the recent pensions White Paper), and a DC Chair's statement is already required. It would be simple to implement a requirement to report on switching costs within those statements.
- 3.7 Trustees are also required to complete a 'Scheme Return' and send this to tPR each year. If trustees were required to detail particular steps that they had taken to review their IC or FM firm relationship in that document, trustees would naturally be more proactive in seeking out relevant information from their IC or FM service provider.
- 3.8 In terms of specific new obligations on IC or FM firms, we are concerned to understand how it would be possible to project exit costs from an IC or FM services contract, when the size and shape of a client's investments at the end of a client relationship is not known at the start of that relationship. While it would be possible to give an indication of current exit costs, this would provide limited guidance for the future.
- 3.9 We are also supportive of the work of the FCA's Institutional Disclosure Working Group ("IDWG") which has been convened following the FCA's asset management market study. We consider that increased disclosure will be important in enhancing value and encouraging better behaviours. A clear understanding of the transaction costs incurred by the managers underlying the old and new portfolios during the switching process would enable the IC/FM to better assess which asset managers represent value for their clients. It would also, in turn, enable the IC/FM firm to provide its clients with clearer disclosures concerning switching costs.

#### Measures to reduce switching costs

- 3.10 The costs of switching are not driven to a material extent by any fees that may be imposed by the IC or FM, which are minimal, but rather by underlying asset manager fees, in particular transaction costs, which are in turn passed on to clients. Reducing these asset manager fees is therefore essential to ensuring that switching costs are fair and reasonable.
- 3.11 We would welcome any remedies that seek to lower transaction costs and encourage the CMA to support ongoing FCA initiatives in this area. All of the transparency measures which we discuss above are relevant to this, because in our experience, the greater transparency there is on costs, the more scope there is to drive these down.

#### Measures to empower and incentivise trustee boards to engage

- 3.12 The CMA has made a number of sensible suggestions on potential approaches to drive trustee board engagement, although the risk of unintended consequences is present in this area too.
- 3.13 **129(a)** – As we have set out above, trustees already enjoy access to extensive guidance. It may therefore not necessarily be the case that *more* guidance is needed – it should simply be as effective as possible. This could mean re-writing

existing guidance or even withdrawing older guidance to reduce the risk of conflict or ambiguity over what is expected of trustees.

3.14 **129(b)** measures to improve governance standards:

3.14.1 Mandating the use of professional trustees is generally resisted by tPR and the industry as lay trustees who represent pension scheme members are considered preferable (albeit that tPR has already put in place more stringent requirements for master trusts, in the form of a Code of Practice coming into force on 1 October 2018).

3.14.2 There are already statutory requirements around knowledge and understanding for trustees (including lay trustees) and strengthening minimum requirements could discourage individuals from applying to be trustees. Nevertheless, a more rigorous and organised way of tracking trustees' knowledge and understanding could be implemented easily and would have value. This could be done by requiring trustees to submit training records on an annual basis – for example in the scheme return or by way of a response to a question in the annual chair's statement. In our view, there might also be a role for updating and improving the tPR's Trustee Toolkit to track trustee knowledge and understanding.

3.14.3 Greater scheme sponsor involvement in the investment sphere is challenging and care would need to be taken in how that involvement were framed. At the moment, trustees have, effectively, complete control over the investment of scheme assets and any perception of director or indirect sponsor control would be highly sensitive and politically charged given the recent high-profile sponsor failures and pensions impact on scheme members as a result (Tata Steel, BHS, Carillion etc). The WP already notes that greater sponsor involvement would need to be consistent with pension scheme trust deeds. However, in our view it is not possible to introduce governance standards which only apply to schemes to the extent that their trust deeds do not conflict with them. In practice, new legislation would be required with an overriding effect to avoid having a two-tier governance framework.

3.15 **129(c)** – we agree that an obligation on trustees to 'secure value for money' is an attractive concept but it would be important to consider carefully how this could be objectively measured and consequently how such an obligation could be enforced.

3.16 **129(d)** – we fully endorse measures to increase trustee choice but we would stress that any mandatory tendering remedy would need to ensure that the costs involved, particularly for our clients and, ultimately, members, are not disproportionate to the benefits. It can add costs for trustees who have no need to tender and also significantly reduces their commercial flexibility, especially with respect to the many very small DC schemes, who use master trusts, that have been established since the introduction of auto-enrolment rules. This is a complex issue that it is premature to discuss.

3.17 **129(e)** – we agree that there could be value in trustees reporting to scheme members or tPR.