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Dear Peter

Response to Working Paper: Trustee engagement

We have pleasure in providing some comments on the above paper and responses to the proposed remedies.

On the general content of the paper we felt that this was a good account of the issues. We also believe it recognises that resolution is not straightforward and there is a danger of unintended consequences. We would wish to make a few observations prior to addressing the proposed remedies.

First, we note the 4 headline indicators set out in paragraph 3. We would question whether a lack of the first, second and fourth indicators (switching, tendering and/or switching and external review) are good indicators of a lack of engagement?

A satisfied board of engaged trustees would not necessarily feature in these, but we do recognise that trustees need to be engaged and well informed to prevent false positives. This is where we would fully support the third indicator (formal review) as a tool to drive engagement, assess the quality of advice and fees. Whether this is made mandatory or best practice we are sure will emerge from your study. Our view would be to increase the perimeter of FCA regulation, operating on a principles based set of requirements of which this would be a key feature.

Second, one of the findings is that there is little challenge of the investment consulting advice provided. We would submit that there is a difference between understanding and challenge. It is not one-size fits all, and one of the skills of a good investment consultant is to use their knowledge of the wide range of strategies, managers, and approaches to implementation and to present a solution that best fits their needs and their preferred approach to running their scheme. A good investment consultant also works with the client to make sure that it understands the advice being provided at the decision making point. It is therefore often the case that the client can make an informed decision to accept the advice provided without challenging the advice, because the advice is well tailored to its circumstances.

Third we believe it needs to be clear what good (and necessary) switching costs are and which are bad and in need of control and reduction. The need for switching arises under 4 headings and the characteristics we note below.

- Replacement of IC advisor. The costs of switching IC advisor we agree are minimal. However if this results in a change of strategy then there will be additional rearrangement costs. These we regard as necessary and a table similar to that in paragraph 169 would be a useful tool to assess the costs of this rearrangement. The majority of these costs are “good” but there can be features of the construction of portfolios which could introduce bad costs, particularly unjustified lock-ins and exit penalties. The exit terms of such constituents should be clearly identified prior to selection.
- Replacement of Asset Manager. There are definitely costs surrounding this, but some are necessary and others perhaps avoidable; largely around the efficient transfer of the underlying investment. However these also fall under the first bullet.
- Replacement of FM adviser. If there is no change in strategy then these are identical to the second bullet and the same observations pertain. However, if the strategy has been designed such that few other FM providers would be able to provide or replace this service to the client, this then is an exit cost, which disclosure would resolve.
- Change in Strategy. This is identical to the consequences outlined in the first bullet in relation to change of strategy and the same comments apply.

The conclusion is therefore that if the scheme is to switch managers with or without a change in strategy or just put into a different strategy then rearrangement costs are inevitable and beyond disclosure nothing further we suggest is required.

Where actions are required are in the areas of lock-ins, exit penalties, own funds, illiquid investments where the costs of change can be substantial. Here we believe principles need to be established to cover what are acceptable as exit penalties (e.g. to cover the costs of advice where recovery was by virtue of a bps addition over a period of years), lock-in periods and finally disclosure requirements ahead of signing contracts and a cooling off period.

Questions on potential remedies

1) How can switching costs be reduced?

First one needs to define what switching costs refer to as distinct from the rearrangement costs of trading securities. Then, as highlighted above, we believe through regulation there needs to be increased disclosure and transparency of the “exit position” ahead of implementation.

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.

This is a large topic and there are many variants. Through increased disclosure ahead of implementation we believe competition would drive out unacceptable practices, drive reductions in penalties and lock-in periods. It would also put trustees in a position to challenge the reasons for any penalties that exist, and make informed choices before committing to a change.

b) How do switching costs vary by the type of FM service provided, and where specifically are costs incurred.

As discussed in the introduction costs arise through switching of underlying assets, which are a feature irrespective of the type of service. There are then penalty costs and lock-in periods which are directly a function of the type of security (illiquidity etc.) and features of own (in house) funds where there are penalties for exit, lock-ins and general difficulties around switching; for instance multiple-complex derivatives held directly by the trustees through a custodian, We would welcome measures to reduce such barriers and would support regulation if this were felt necessary.

2) Can FM providers present better information on switching and exit costs in advance?

Inevitably the answer has to be yes.

a) What are the challenges for FM providers in providing accurate exit or switching costs in advance, e.g. when tendering?

We believe this needs to be tackled through principles based regulation. Where costs can be illustrated they should be, otherwise the factors affecting these costs need be fully explained with indications of the impact, not only of monetary costs.

Perhaps a separate statement on the extent of forced encashment of holdings on entrance/exit to the FM, rather than transfer by novation of the underlying asset, may emphasise this point.

b) What are the key drivers of the cost of switching and should these be disclosed separately?

As explained in the introduction these are the sell/buy costs of trading securities to reflect the new strategy. Second there are the costs surrounding the advices on a change in strategy, but believe this is not the focus here. Third there are penalty charges and in some cases the costs of being forced to sell to cash rather than facilitating in specie transfers. Transparency would suggest separate reporting of the different elements.

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?

First there needs to be the monetary costs, which could then be annualised over say 3 years and expressed as the equivalent bps on the relevant assets. This then demonstrates the additional return which would be required to recover and justify the switch. This should only relate to assets traded for a better return. Assets traded to reflect a documented change in strategy, which would provide risk management benefits would need to be differently treated in that it is rarely merely a change in return which is being sought.

d) What would a meaningful benchmark for switching costs be?

As highlighted above, the kind of table referred to in paragraph 169 would be a good guide to what is reasonable. However, this table only covers the more generalised funds and does provide some difficulty as a client should already be using the realisable value of the asset for formal valuation purposes, and this should therefore already factor in exit costs for many asset types.

e) Could the provision of information on switching costs to trustees discourage tendering or switching?

Inevitably costs are always a possible deterrent to action. However, transparency should be welcomed, and it should be important for trustees to be aware of potential trading costs and barriers (both entry and subsequent exit) before proceeding with a planned course of action. This will put trustees in the position to make an informed decision to weigh up costs with what is trying to be achieved (extra return, reduction in volatility, flight path, change of strategy).

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?*

In answer to all these questions we believe that there needs to be a wider perimeter of regulation on a principles basis. This should be drafted most importantly to drive greater engagement resulting in greater and more consistent disclosures of returns, costs, performance against objectives, such that competition can drive better outcomes.

We also support your preferred approach in relation to engagement being to provide support to trustees, access to information, and resources to reduce the cost of testing the market. This is consistent with our response to previous working papers, and our support for a framework that drives transparency, provision of information and also proportionality of approach that would allow (especially smaller) clients to choose their preferred approach taking into consideration their own circumstances and preferences.

We do hope you find our comments useful. If you have any queries in respect of our response or more generally please get in touch with us.

Yours sincerely

Phil Wadsworth

Director