

**CMA INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT
MARKET INVESTIGATION**

MERCER'S RESPONSE TO TRUSTEE ENGAGEMENT WORKING PAPER

This is the response of Mercer Limited (**Mercer**) to the Trustee Engagement working paper (**WP**) dated 12 April 2018.

1 Executive Summary

- 1.1 The evidence cited in the WP demonstrates that trustees have the characteristics necessary for active engagement. In particular, the evidence shows trustees:
- (a) have the skills, capabilities and experience to enable them to make well-informed decisions when acquiring investment consultancy (**IC**) and/or fiduciary management (**FM**) services – more than 70% of trustees have a “relevant” qualification;¹
 - (b) have the ability to challenge their IC and/or FM providers and regularly do so – 70% of respondents to the CMA’s survey stated that they had challenged their IC to improve their terms within the last three years;² and
 - (c) apply competitive pressure on their providers; indeed, this is even more obvious in the case of trustees who purchase multiple services from the same provider.³
- 1.2 We do not believe the CMA has fully considered certain factors which may explain the apparent evidence of lower trustee engagement in the case of:
- (a) Defined contribution (**DC**) schemes. The operation of DC schemes is different from defined benefit (**DB**) schemes in terms of governance and regulatory requirements. DC scheme investments are typically less complex (than DB) and more strategic in nature. As a result, there tend to be fewer short-term interventions which, in turn, allows DC scheme trustees to manage their “engagement budget” efficiently.
 - (b) FM. As noted by the CMA, FM is a relatively new and rapidly growing market.⁴ It would be inappropriate to give undue weight to lower levels of switching in FM or rely on formal measures of engagement given most of these clients have only recently adopted FM services.
- 1.3 The evidence does not appear to reflect barriers to trustees *accessing* or *assessing* relevant information. In fact, as previously highlighted, the CMA’s survey demonstrates that the vast majority of trustees (at least 80%) find it “very” or “fairly” easy to understand information from their IC and/or FM providers.⁵ Trustees generally appear satisfied with the information made available to them and confident of their ability to evaluate their providers.⁶
- 1.4 In terms of whether trustees are able to *act*, we are concerned with the CMA’s approach to considering the cost and barriers to switching. In particular, in relation to FM switching costs:
- (a) Changing FM provider, or switching to FM from IC, usually leads to a change in investment strategy because most if not all of the client’s investments will be transferred to new funds at the time of the switch. This change in investment strategy creates transaction costs.

¹ WP, paragraph 41. This is based on the survey by IFF Research (referred to in this response as the **CMA’s survey**).

² WP, paragraph 67.

³ WP, paragraph 58(d).

⁴ WP, paragraph 63.

⁵ See paragraph 1.1(a) of our response to the CMA’s working paper on *Information on Fees and Quality* (submitted on 22 March 2018) summarising the results of CMA’s survey.

⁶ CMA survey, page 15.

- (b) Transaction costs would be incurred on any change of strategy – indeed, changing IC can also lead to significant strategy changes which would create transaction costs. However, in a change of IC, these costs tend to occur gradually over a period after the IC is appointed, rather than all at once at the time of the switch (as is the case for FM).
 - (c) These transaction costs are ultimately paid to banks and brokers that trade securities. They are not controlled by FM providers and, therefore, are not within FM providers' power to reduce.
- 1.5 To the extent the CMA has identified varying or inconsistent levels of engagement, these do not point to an adverse effect on competition (**AEC**).
- (a) Different levels of engagement are to be expected according to factors such as the type of scheme (as mentioned above) and the size of scheme. Lower levels of engagement from smaller schemes are likely to be reflective of their having less complex arrangements which require less active on-going management. For some smaller schemes which may have less governance resource, a FM solution may be an attractive option to reduce the need for frequent engagement.
 - (b) It would be inappropriate to give undue weight to levels of switching as a measure of engagement. Indeed, given the typically long-term nature of the investments, FM and IC do not naturally lend themselves to frequent levels of switching.
 - (c) As the CMA itself notes, the Pensions Regulator (**tPR**) is already implementing a number of initiatives which – once they have been allowed time to bed in – should introduce changes in the market in terms of raising standards of engagement to a more consistent level across trustees.
- 1.6 As no competition concern has been established, we consider it inappropriate for the CMA to consider remedies in detail at this stage. We agree with the CMA's intention to ensure that, should it identify any AEC, any potential remedy imposed is meaningful. Accordingly, we highlight the risk of unintended consequences of regulatory interference such as introducing "tick box" exercises or imposing unnecessary costs on market participants. Further, there is the risk that the introduction of a standard will effectively be set at the lowest common denominator; an outcome which is likely to be detrimental to clients.
- 1.7 We set out in the following sections detailed comments on the CMA's emerging findings. Notwithstanding our view that the level of trustee engagement does not require the imposition of remedies, we also provide preliminary comments on the potential remedies under consideration by the CMA.

2 Trustee engagement

- 2.1 Overall, the evidence cited in the WP does not support a finding of a potential competition concern in connection with levels of trustee engagement. Trustees appear able to assess the value for money of alternative providers, and (where appropriate) to *act* on the outcome of that assessment.
- 2.2 In particular, the evidence points to trustees who are experienced, diligent, capable, and are willing to question and challenge advice. This is consistent with our own experience of working with trustees.
- (a) **Trustees have the skills, capabilities and experience to enable them to make well-informed decisions when acquiring IC and/or FM services.**

- (i) The CMA finds that trustees have, on average, 11 years of experience and that this is broadly consistent across types and size of scheme.⁷
 - (ii) Moreover, 70% of non-professional trustees have a “relevant” qualification. This figure rises to 89% for professional or corporate trustees.⁸
 - (iii) The CMA cites research which indicates that trustees are experienced, well-educated and financially sophisticated.⁹ For instance, trustees’ financial literacy is at the highest level, and four out of five trustees are educated to degree-level or higher.
- (b) **Trustees have the ability to exert competitive pressure and are more likely than not to do so.**
- (i) Although the CMA’s analysis of four “headline indicators”¹⁰ points to a “clear and consistent pattern” that larger schemes are more engaged than average, the only category in which smaller schemes appear less engaged, to a statistically significant degree, is in relation to formal review of fees and/or quality.¹¹ Smaller schemes may have less complex arrangements requiring less active on-going engagement as compared with larger schemes. For some smaller schemes which may have less governance resource available, a FM solution may be an attractive option to reduce the need for frequent engagement.
 - (ii) The results of the CMA’s “headline indicators” analysis (in particular the levels of switching and tendering) also illustrate the competitive constraint imposed on Mercer by other ICs.¹² This matches our own experience of the market. We face consistent pressure to keep and win clients. If we do not meet our clients’ expectations, clients can and do switch away from us to an alternative provider. Even if a customer chooses not to switch, organising a tender and testing the market is enough to enable trustees to put pressure on their provider to lower fees and/or improve quality.¹³
 - (iii) As noted by the CMA, a number of firms have reported that they are frequently challenged by their clients, which corresponds with Mercer’s experience. Indeed, 70% of respondents to the CMA’s survey stated that they had challenged their IC to improve their terms within the last three years.¹⁴ This is likely to increase with the rise in professional trustees¹⁵ and the introduction of recent initiatives by tPR.¹⁶
- (c) **Trustee engagement appears higher for those trustees who purchase multiple services from the same provider.** Contrary to any theory regarding potentially inappropriate cross-selling in the market, the CMA finds that:
- (i) Those schemes that purchase FM services from their IC provider are “*more likely to undertake an external review of fees and/or quality*”.¹⁷

⁷ WP, paragraph 40.

⁸ WP, paragraph 41.

⁹ WP, paragraph 46.

¹⁰ WP, paragraph 54. The CMA assesses engagement across four “headline indicators” across different scheme types and by the number of services purchased. These indicators are: (1) switching, (2) tendering and/or switching, (3) undertaking a formal review of fees and/or quality, and (4) undertaking an external review of fees and/or quality.

¹¹ WP, Table 3.

¹² WP, paragraph 59 and Table 3.

¹³ WP, paragraph 54(b).

¹⁴ WP, paragraph 67.

¹⁵ WP, paragraph 69.

¹⁶ For example, the ‘Trustee Toolkit’ (<https://trusteetoolkit.thepensionsregulator.gov.uk>).

¹⁷ WP, paragraph 58(d) – emphasis added.

- (ii) Those schemes that purchase both IC and FM services from the same provider are more likely to exhibit positive behaviour across all four “headline indicators” of engagement – and not just in relation to conducting external reviews of fees and/or quality.¹⁸
- (iii) Further, there is “little evidence that bundling services (e.g. by purchasing IC and actuarial services from the same provider) reduces engagement”¹⁹ and “no evidence” that schemes that specifically bundle IC, actuarial services and administration services together are less likely to be engaged than those that do not.²⁰

The evidence gathered by the CMA on these “headline indicators” further supports our comments regarding trustee engagement in response to the CMA’s working paper on the *Supply of Fiduciary Management by Investment Consultancy Firms*.²¹

2.3 However, there are certain aspects of the evidence where we disagree with the CMA’s interpretation. In particular, our view is that:

(a) **When assessing engagement levels, the CMA should take into account that the characteristics of DC schemes differ from DB schemes.**

- (i) The CMA notes that DC schemes “*appear to be significantly less engaged than average*”;²² however, the governance of DC scheme investment is different from DB schemes.²³ In designing investments for DC schemes, the primary focus is on the individual member, with a strong emphasis on delivering transparent, good value outcomes. Thus, the investment strategies trustees make available for DC scheme members are fundamentally different from those of DB schemes; in short, they are designed at an individual fund level rather than at scheme level.
- (ii) The guiding theme is that DC investment arrangements should meet members’ needs for growth, inflation protection and capital preservation, with the goal to achieve overall pension adequacy and affordability and provide good value.
- (iii) That said, over [3<] of members invest all their contributions through default arrangements. This has implications for engagement. Trustees recognise that frequent change of the default strategy will have cost implications to the member, along with the costs of additional communications and administration. For this and other reasons relating to the nature of DC, it is common to see trustees avoiding direct investment in more expensive, segregated or illiquid investment strategies.
- (iv) Other ways in which DC trustees seek efficient default design is through delegation of active asset allocation decisions to a diversified growth fund manager, and use of passive management. Pooled funds and platforms help further with investment governance. Therefore, member investments are relatively sophisticated, albeit wrapped in an accessible way. As such, trustees can keep their focus on ensuring their main investment vehicle is maintained and monitored regularly.
- (v) DC trustee engagement is, therefore, typically focused on quarterly monitoring of the main default arrangement and any additional self-select options made available

¹⁸ WP, Table 3.

¹⁹ WP, paragraph 58(d) – emphasis added.

²⁰ WP, footnote 28 – emphasis added.

²¹ See paragraphs 1.1(a)(ii) and 2.1(c) of our response dated 17 April 2018.

²² WP, paragraph 3(a).

²³ We note the pool of survey respondents that had purchased Master Trust services was not deemed sufficiently substantial for the CMA to draw any conclusions on the level of engagement amongst Master Trust purchasers. As such, we would strongly caution against the CMA automatically assuming that any conclusions it draws in relation to DC schemes apply equally to the Master Trust market.

to members. Further, and in line with the different regulatory and governance requirements that apply to DC schemes,²⁴ assessments of value for money take place on an annual basis. These involve scrutiny of investment costs and charges.

- (vi) In addition, DC trustees formally undertake a review of their investment strategy and statement of investment principles every three years in line with statutory requirements (or more frequently subject to regulation or fund manager events).²⁵ At this point, fuller consideration, among other things, is given to the profile of the membership, investment “glide path” design, costs, regulatory changes, investment beliefs and distribution of outcomes for members.
- (vii) Therefore, well designed DC schemes should be able to withstand different market environments without constant changes from trustees. Nevertheless, trustees will actively monitor the impact on member investments during times of market stress, albeit more to ensure the robustness of their scheme design rather than to be “tactical” in changing investments.
- (viii) We believe this distinction also explains the less frequent use of investment sub-committees (ISCs) in DC schemes.²⁶ Adopting more of a strategic view of DC investments and delegating more of the detail has allowed most DC scheme trustees to make better use of their “engagement budget”, particularly given the ever-demanding regulatory and legislative environment.
- (ix) To the extent DC schemes could be doing more to monitor “member outcomes”,²⁷ tPR is well placed to enhance its current oversight role. We believe the effective enforcement of existing regulation and more proactive engagement to support trustees would be helpful. We caution against the potential risks of introducing further regulation in this area at the expense of overburdening trustees’ “engagement budget”.

(b) FM is a growing market with positive signs of trustee engagement.

- (i) We believe the CMA has given insufficient regard to its observation that a low overall rate of switching in FM compared with IC could “*reflect the fact that FM is an emerging service*”.²⁸ We do not consider switching levels to be a reliable measure of engagement in the case of FM given that clients are relatively new to FM services, meaning that levels of switching and tendering in FM are in any event likely to be lower than for a more established market.
- (ii) Similarly, we would expect the CMA to take into account other measures of engagement and, in particular, the evidence it has gathered regarding trustees’ monitoring of performance and fees. A very high proportion (92%) of survey respondents highlighted the ease of FM understanding providers’ performance, suggesting good levels of monitoring.²⁹

2.4 We recognise that engagement levels may vary from scheme to scheme. We believe that tPR is best placed to address this, particularly given its ongoing work in this area. The evidence the CMA cites to indicate trustee shortcomings is largely from tPR’s 2015 *Trustee Landscape* survey.³⁰ A number of tPR initiatives are already in motion following this survey and have the

²⁴ As noted by the CMA in its working paper on *Information on Fees and Performance*.

²⁵ Occupational Pension Schemes (Scheme Administration) Regulations 1996, regulation 25(1), SI 2005 No. 1715.

²⁶ However, ISCs are reasonably common among larger DC schemes with direct investment and complex multi-manager default and self-select arrangements.

²⁷ WP, paragraph 73.

²⁸ WP, paragraph 62.

²⁹ 92% of fiduciary clients find it either “*very easy*” or “*fairly easy*” to monitor overall investment performance

³⁰ WP, paragraph 6.

objective of raising standards among trustees. These initiatives should be allowed to bed in and make an impact. Accordingly, it is important that the CMA coordinates with tPR in light of the changes already underway in this area.

3 The switching process and cost

- 3.1 In this section, we comment on the evidence and emerging findings presented by the CMA in connection with the IC and FM switching process and cost. Our high level responses to the questions posed by the CMA in the WP are included in Section 4 below, where we also make more general comments about the CMA's approach to, and design of, potential remedies concerning switching processes and costs.

Switching IC provider

- 3.2 The primary reason given by trustees for not switching IC – satisfaction with current provider³¹ – ties in with similarly high levels of satisfaction found elsewhere in the survey.³² The choice not to switch or tender appears to be a conscious decision on the part of those trustees. The survey results show that only a very small number of those who have not switched or run tenders have not given consideration to doing so (4%).³³
- 3.3 Notably, the CMA finds that 82% of respondents that switched IC provider within the last five years found the process of switching “very easy” or “easy”.³⁴ Of those that had not switched from their current provider (and had not run tender exercises), not a single respondent cited a previous bad switching experience as the reason. This result is not indicative of a demand-side that is facing significant barriers to switching provider.

Switching FM provider

- 3.4 We agree with the CMA that the overall timings and costs of switching vary considerably on a client-by-client basis and that the key drivers are the type of assets held by the client, and the overlap between the origin and destination portfolios.

Timing of switching in FM

- 3.5 The timeline for switching FM provider is typically a number of months. This period is split between the strategic planning phase – the most time-consuming component of the overall switching process – and the asset transfer process. In the strategic planning phase, the new FM provider works with the client to decide the most appropriate approach to reach the client's funding goals. It is important that any new strategy is fully considered and tailored to the specific needs and objectives of the client. We caution, therefore, against measures that place pressure on this timeline.
- 3.6 Once the planning is complete, the asset transfer phase may often be completed relatively quickly. For Mercer's full FM clients, it is usually possible to buy/sell assets on a daily basis and they can, therefore, be exited or entered within a week from the redemption request. However, as the CMA itself notes, the transitioning of assets may take longer depending on the nature of the assets in question.³⁵ This is a result of the characteristics of the investment and *not* the FM provider.
- 3.7 The CMA also draws a comparison between the switching process in IC as against FM, and finds that it generally takes longer to switch in FM than IC. The CMA appears to accept the

³¹ 75%. See Figure 4.4 of the CMA survey results.

³² 95% of purchasers of IC and FM services either ‘very’ or ‘fairly’ satisfied. CMA survey, page 14.

³³ IFF Research data tables for all scheme types, Table 80.

³⁴ CMA survey, page 16.

³⁵ WP, Annex 3, paragraph 164.

reasons for this are self-evident.³⁶ In IC, revisions to a client's investment strategy are typically made *after* the new IC has been appointed. Indeed, once a client has changed IC providers, it can take, perhaps, six months to appoint new underlying asset managers (although the timeline will vary on a case by case basis).

Level of switching costs in FM

- 3.8 We believe that the costs of switching FM provider or switching into FM for the first time are not unduly high, especially when considered in context. By highlighting that “*switching costs [in FM] could... be equivalent to an additional year’s worth of FM fees*”, the CMA fails to acknowledge the nature of FM services.³⁷ This is not a market where we would expect clients to switch frequently (or rapidly after selection of a new FM provider) due to the intended long-term nature of the investments. As noted by the CMA, for a scheme with 50% in growth assets, the transaction costs typically incurred when disinvesting from Mercer funds would not be more than [~~3~~] of assets. In this context, these costs are not likely to discourage clients from switching.³⁸
- 3.9 Further, the level of switching costs is generally dependent on the degree of change in a client's investment strategy. Switching FM provider, or moving to FM for the first time, involves an upfront and significant revision to the client's investment strategy.³⁹ This typically means withdrawing the portfolio from the previous providers' fund choices and reinvesting into those of the new FM provider. By contrast, when switching IC providers, changes to investment strategy are more likely to happen gradually and after the change of provider has been effected. As such, although strategy changes resulting from an IC switch will take place over a longer period than FM, they may also involve transaction costs, albeit not incurred upfront.
- 3.10 Finally, these transaction costs are ultimately paid to banks and brokers that trade securities.⁴⁰ Transaction costs are predominantly determined by the origin and destination asset classes involved in the transition and are not paid to, or determined by, FM providers. For the avoidance of doubt, Mercer does not receive any financial benefits from the activity involved in the on-boarding or off-boarding of client assets.
- 3.11 We respond to the CMA's questions on potential remedies below and set out high level comments on the three broad areas where the CMA is seeking further input to inform any potential remedies, as set out at paragraph 131 of the WP.
- (a) **The structure of switching costs**
- (i) To answer the CMA's question on the extent to which switching costs are avoidable or controllable, transaction costs are not controlled by FM providers (as mentioned above). Therefore, we do not see how transaction costs can be directly reduced by these providers. However, these costs should be transparent. When assessing the merits of switching to FM or between FM providers, trustees can and, in our experience, do ask for an estimate of the relevant transaction costs.
- (ii) Transition coordination services, such as those provided by Mercer Sentinel, can help to limit trustees' “out of market” exposure and, therefore, overall switching costs.
- (b) **Reducing costs in transferring assets**

³⁶ See e.g. WP, paragraph 113: “*In contrast, it is our understanding that the upfront timings and costs for switching IC provider are minimal.*”

³⁷ WP, paragraphs 103 and 173.

³⁸ WP, paragraph 171(a).

³⁹ WP, paragraphs 8 and 94-95.

⁴⁰ WP, Annex 3, paragraph 168.

- (i) To answer the CMA's question on what drives the cost of switching, in our experience, the nature of the client's portfolio and the investment decisions made by the client are key factors.
 - (ii) In-specie transfer of assets can help to reduce transaction costs incurred by a client where possible and we offer these if appropriate.
 - (iii) The use of pooled fund structures in FM can help with the efficient on-boarding and off-boarding of assets. For example, this can help clients reduce costs as it means they are not required to negotiate and agree IMAs with individual managers or to enter into custody agreements that would result in legal and other third-party costs being incurred.
 - (iv) [X]
- (c) **Implicit costs of switching**
- (i) To answer the CMA's question on the costs incurred by FM providers in winning a new engagement, these costs will vary depending on each client's circumstances. For instance, these implicit costs may vary depending on the length of the RfP (e.g. the number of questions, stages in the selection process, etc). For smaller mandates the overall cost can be a significant proportion of the first year revenue that we expect to generate from that appointment.
 - (ii) The typical implicit costs we would expect to incur include:
 - (A) The cost of the appointment process itself, which includes the costs associated with:
 - responding to RfPs (writing, reviewing, peer review, etc);
 - attendance at presentations; and
 - preparation of the contract and fee negotiation process.
 - (B) The cost of developing the appropriate client solution, including:
 - developing initial strategic asset allocation; and
 - company and trustee consultation.

Transparency of switching costs in FM

- 3.12 The CMA sets out a series of proposed remedies it wishes to explore concerning the provision of information on FM switching costs to trustees. Specifically the CMA is considering:
- (a) introducing an obligation on firms to disclose FM service exit costs; and
 - (b) requiring firms to contextualise FM service exit costs.
- 3.13 We consider that the CMA is right to be cautious of benchmarking potential switching costs. It is difficult to envisage how this would work in practice given that the origin *and* destination portfolios for each individual client will differ. Moreover, benchmarking these costs could discourage clients from switching provider and investment strategy in circumstances where it is in the client's best interests to do so.
- 3.14 When requested, we provide prospective FM clients with information on expected transaction costs before transition. In our experience, it is increasingly common for trustees to request an estimate of expected transaction costs during the RfP stage of the switching process.
- 3.15 In addition, clients that decide to implement Mercer FM have the option of using Mercer Sentinel to support the transition process. Mercer Sentinel's service will include providing the client with

an estimate of expected transaction costs. Post-transition, Mercer Sentinel will report back to the client on how this estimate compared to the transaction costs actually incurred.

- 3.16 It is our experience that trustees have a good understanding of likely transition costs, and we do not consider that the CMA has provided significant evidence to the contrary. On this basis, we consider any potential remedies in this area run the risk of being disproportionate (and potentially damaging).

4 Potential remedies

- 4.1 For the reasons set out above, we do not consider that the CMA's evidence supports an AEC finding that would justify the imposition of remedies. As we have submitted previously, we urge the CMA to avoid the temptation to "reverse engineer" a finding of an AEC to justify the imposition of remedies that might appear, at face value, broadly beneficial.
- 4.2 In this context, we are pleased to note that the CMA is aware of the potential unintended consequences of introducing remedies in this area. We welcome the CMA's statement that its preferred approach is to provide support to trustees by ensuring sufficient access to information.⁴¹ While this comment is made in the context of reducing the cost of testing the market, the principle extends to all areas of trustee engagement. More interventionist measures are likely to lead to unintended consequences – including potentially stifling innovation, promoting a "tick box" approach, and imposing unnecessary costs (as the CMA itself notes).
- 4.3 We agree that tPR is best placed to issue any additional or streamlined guidance for trustees. This appears to us sensible given the various on-going initiatives undertaken by tPR and DWP to support trustees.
- 4.4 We also welcome the CMA's acknowledgment that there are risks to imposing requirements to conduct tender processes or to mandate switching which will introduce additional cost.⁴² As we have previously submitted, any mandatory tendering or switching regime risks introducing bureaucracy and cost while failing to achieve the objectives sought. Moreover, it would fail to reflect the different needs and characteristics of individual pension schemes. For example, schemes with professional trustees may have sufficient knowledge of the market that they do not feel the need to run a formal tender, whilst for smaller schemes prescriptive tendering / switching requirements may impose a disproportionate cost burden. There is no one-size-fits-all approach and none should be imposed.
- 4.5 A key driver of the costs of switching will always be the nature of the client's portfolio. As mentioned above, the bulk of switching costs are unavoidable market costs directly related to the transitioning of assets and are not payable to FM providers. We do not believe there are any potential remedies that could realistically reduce these unavoidable costs without potentially leading to an inferior and riskier investment strategy.
- 4.6 Finally, any requirement on FM providers to provide specific information on switching and exit costs in advance should not be prescriptive. As a client's switching costs will depend heavily on their individual portfolio, it may not always be straightforward to provide full details early in a tender process – i.e. before strategic planning of the future of the portfolio has been completed. Requiring estimates to be provided too early in the process could lead to an unduly conservative approach being taken to allow for all the potential variables – and thus risk actually discouraging, rather than encouraging, switching.

⁴¹ WP, paragraph 134.

⁴² WP, paragraph 134.