Willis Towers Watson

INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

RESPONSE TO WORKING PAPER ON BARRIERS TO ENTRY

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10 MAY 2018

INVESTMENT CONSULTANCY ("IC") AND FIDUCIARY MANAGEMENT ("FM") SERVICES

WTW RESPONSE TO WORKING PAPER ON BARRIERS TO ENTRY AND EXPANSION[1]

1.1 WTW welcomes the opportunity to respond to the working paper on barriers to entry and expansion published by the CMA on 26 April 2018 (the "**Working Paper**").

1.2 A balanced assessment of the evidence that the CMA has considered in the Working Paper points to the following conclusions:

(a) First and foremost, any barriers to entry and expansion that do exist are demonstrably low, as shown by the large numbers of successful entrants into both the IC and FM markets in recent years.[2]

(b) Second, as the Working Paper itself recognises, an assessment of the steps required to set up a new IC or FM service confirms that there are no significant barriers to entry for either type of service.[3]

(c) Third, an assessment of the steps required to attract clients similarly shows that there are no significant barriers to expansion for either IC or FM services. Certain factors – such as the importance of developing a strong track record and the frequency with which services are re-tendered – can place a natural "speed limit" on the rate at which firms are able to expand their business in both IC and FM. However, the scalability of both IC and FM services means that firms of a range of sizes can – and do – effectively compete for business on a sustainable basis. A number of firms have started out as "niche" providers and have successfully grown both the scale and scope of their services over time.[4]

1.3 We explain each of these conclusions in turn below. We also have two cross-cutting observations that apply to the Working Paper's comments on both barriers to entry and barriers to expansion in equal measure:

(a) Many of those "barriers" to entry and expansion that the Working Paper has considered – such as research costs and the "incumbency advantage" that comes with investing resources in developing a deep understanding of clients' goals and needs – are essential to providing the type and quality of service that clients demand. These should not be thought of as "barriers", since the only way to "remedy" them would be forcibly to impair the services that firms provide to these clients, which would patently be detrimental.

(b) We also do not agree with the Working Paper's suggestion that barriers to entry and expansion are materially higher for FM services than for IC services. On the contrary, in some respects there are stronger opportunities for new entrants to establish themselves and grow their client base in the context of FM than in the context of IC as a result of the increased uptake of the FM model by pension scheme trustees.

[1] In this response and all responses to the CMA, Towers Watson Limited is the main regulated entity. We refer to both this entity and the relevant general business as "We", "Willis Towers Watson" or "WTW" throughout.
[2] Figure 1, page 5 of the Working Paper.
[3] Paragraph 8 of the Working Paper.
[4] See case study of Redington at page 13 of the Working Paper.

Any barriers to entry and expansion that do exist are demonstrably not insurmountable

1.4 In the Working Paper, the CMA lists the features of a market that can theoretically give rise to barriers to entry and expansion respectively and then assesses each of these features in turn in the context of IC and FM services. While this is a sensible approach, the CMA should not lose sight of the overarching fact that these features clearly do not give rise to insurmountable barriers to entry or expansion, either individually or collectively. On the contrary:

(a) There have been high and sustained levels of entry across both IC and FM services in the UK over the past decade. As illustrated by the findings of the CMA in the Working Paper, the IC and FM markets have been growing since 2007, with the number of firms active in these markets increasing steadily – there have been 12 IC entrants and 12 FM entrants since 2008 – and no firms exiting.[5]

(b) A wide variety of smaller firms, such as Momentum Global Investment Management, Redington and SEI, have been successful in expanding their IC and FM businesses over the same period.

There are no significant barriers to entry for either IC or FM services

1.5 We agree with the CMA's conclusion that there are no significant "natural" or "intrinsic" barriers to entry in either the IC or FM markets. The CMA also rightly recognises that the costs of providing advice are largely scalable in the sense that they broadly increase in proportion to the size of a firm's client base rather than requiring substantial upfront investments.

1.6 However, the CMA also suggests that FM services may be characterised by more significant economies of scale than IC services, because FM may "require a larger fixed cost base for a research function and this does not grow in proportion to the number of clients"[6]. We note the following in relation to this statement:

(a) First, an effective research function is intrinsic to the services provided by FM firms. A full FM service needs to be capable of making informed decisions about a wide spectrum of investment opportunities, given the remit of the FM provider, and therefore needs to be supported by a full research function. Under an IC model, by contrast, providers have the option of offering "niche" services that provide advice on certain types of investment, and so do not necessarily need to offer a complete spectrum of research. As we have explained in previous submissions, the wide-ranging remit of the full FM service is integral to the additional value that it creates for clients. We provided a detailed submission to the CMA in January 2018 that set out evidence to show the value that our FM services create for clients in this regard.

(b) Second, despite the increased use of research as part of providing an effective FM service, there has still been a number of notable new entrants into the market. This suggests that building a research function is not a significant barrier to entry. For example, a number of new asset manager entrants in the FM sector have developed offerings focused on existing index racking implementation which requires very low levels of new investment to be used within an FM mandate.

There are no significant barriers to expansion for either IC or FM services

[5] Paragraph 15, Figure 1 of the Working Paper.
[6] Paragraph 35 of the Working Paper.

1.7 The CMA identifies three factors that it suggests may make it harder for firms to win new FM clients, thereby generating higher barriers to entry in FM services than in IC services. In our view, the CMA has overstated the scale and impact of these points, and has understated the relevance of countervailing factors that make it easier for firms of all sizes to compete effectively for FM business over the coming years.

1.8 First, the CMA suggests that levels of switching in FM are lower than in IC, and that this may mean that there are "proportionately fewer opportunities in FM to win new clients and expand"[7]. We disagree with this assessment.

(a) The statistics that the CMA has quoted only consider switching within FM, as opposed to the substantial amount of switching from IC to FM. In WTW's experience, the large majority of clients who have decided to migrate from IC to FM have run a competitive tender process to select their FM provider and in the majority of cases the winner is not the existing IC provider.[8] The trend in customers switching from IC to FM has therefore created significant opportunities for firms to grow their FM client base and a range of firms have successfully taken advantage of this.

(b) Further, there is particularly strong growth in the FM market, creating more opportunities for entrants to expand. The growth has been particularly pronounced in FM - KPMG's survey indicates that there were 61 FM mandates (£12bn AUM) in 2007 and 805 FM mandates (£135bn AUM) by 2017.[9] This equates to a 1025% increase. Looking ahead, we believe there is significant potential for further growth in the FM industry, since there are still many clients who currently use IC services, but who would benefit from transitioning in part or in full to an FM service. Eventually this growth potential will level off, but we would expect this to be offset by increases in FM-to-FM switching rates over the coming years, once clients have had sufficient time to assess the performance of their existing FM providers.

(c) The CMA correctly notes that there have been relatively few examples of existing FM clients switching to another FM provider to date. However, this is to be expected given that FM is a relatively new innovation within the industry - most pension schemes with a FM provider would have only recently moved to FM. Therefore, the switching levels within FM will inevitably be lower while the market matures. Further, as explained further in our response to the CMA's working paper on Trustee Engagement, this is an industry where clients have a long-term objective and so long-term relationships are built for the benefit of the client. In any case, we stress that it is too soon to be able to measure the rate of switching in FM.

(d) The survey result for the level of switching in FM cannot be relied on as an estimate of the long run level of switching. Firstly, as explained above, the FM market is too new for a majority of clients to have had sufficient time to assess their first FM provider and hence to have switched. Therefore, even if the CMA had a perfect estimate of today's switching rate, this would not provide a measure of the level of switching one may observe at the point at which the market matures. Secondly, the survey results are quite sensitive to changes in the sample used. IFF Research conducted its analysis on the basis of all responses received; in contrast, the CMA attempted to clean the sample by removing all responses for any trustees that, when asked to name their main FM provider, did not name a provider from the CMA's

[7] Paragraph 13(a) of the Working Paper.

[8] The analysis carried out by IFF Research found that in 39% of cases, the trustee board appointed the incumbent IC provider when first purchasing FM services which was shown in paragraph 5.13 of the Survey report produced by IFF research The CMA's analysis, which excluded responses where the main FM provider named was not in their list of "recognised" FM providers, found that 47% of trustee boards selected their incumbent IC provider at the time as their initial FM provider.

[9] Paragraph 18 of the Working Paper.

list of “recognised” FM providers (they also excluded all responses where the trustees said they didn’t know who their main provider was or refused to provide the name of their provider). The two approaches yield materially different results for the switching rate: while IFF found a switching rate of 17%, the CMA’s result was 9%. The CMA’s approach halved the sample size, leaving 145 observations of FM users and only 13 observations of FM users that had switched in the last 5 years. While we agree that this is a valid sensitivity to consider, the CMA has presented this as their central (and only) case and not made any reference to the results obtained by IFF which provide a more positive picture of the FM market. Our view is that the full range of results should be considered, as it is clear that sample sizes are quite small and results are sensitive to the choice of sample.

1.9 Second, the CMA suggests that it can be harder for less well-known FM firms to develop client relationships because given that "demonstrating capability across all relevant asset classes may take a long time", there is “less scope for FM firms to demonstrate capability and demonstrate reputation”.[10] Again, we do not agree with this assessment.

(a) First, the CMA’s argument is predicated on the assumption that there are fewer opportunities to win new client business in FM than in IC, which we do not agree with for the reasons explained above.

(b) Second, the CMA’s argument overlooks additional considerations that should make it easier for firms to demonstrate their abilities in FM. In particular, for the reasons explained in previous submissions, the outcomes of FM are more measurable than that of IC - it is thus easier to compare the relative performance of competing FM services than the performance of IC services.

(c) This is not to deny that it can take time to establish a strong track record in the provision of FM services, or that firms that can point to a strong existing track record have a competitive advantage over those that cannot. The importance of having a strong track record is a typical – and indeed intrinsic – feature of professional services of this nature, given that clients will want to know that they are choosing a high-quality and credible provider. The CMA has not explained why this should be any more of a concern with regard to IC and FM services – particularly when in practice it is demonstrably not an insurmountable barrier to successful entry or expansion.

(d) Even where firms do not have a long track record in FM, they may operate in parallel markets and may be able to draw on elements of their track record in these areas to help build their reputation. As the CMA has noted, many recent entrants into the FM market segment are established providers of actuarial, IC and/or asset management services.

1.10 Third, the CMA suggests that firms with an established IC client base may have an advantage in winning new FM clients, and that this may act as a barrier to expansion for other firms.

1.11 In relation to the specific situation of IC-FM firms, we agree that IC-FM firms with an established IC client base may in some cases have an advantage when these clients decide to migrate to an FM service. However:

(a) In WTW’s experience, this advantage is not the product of a lack of thought or assessment on the part of clients. As noted above, in WTW’s case, the large majority of clients use a

[10] Paragraph 13 (b) of the Working Paper.

competitive tender process to select their FM provider, indicating that where they select their existing IC supplier to provide their FM services, this is an informed and considered decision.

(b) Indeed, in many cases the existing supplier of IC services to a client will have an advantage for good reason. Not only does it take time for a client to invest in a new relationship with a new provider, but in many cases the features of the existing firm that made its IC services attractive to the client will also make its FM features attractive. (For example, a client that originally chose WTW to provide its IC services because of the strength of its research base is also likely to see this as an attractive feature in WTW when selecting an FM provider.) It would not be appropriate to think of this as a "barrier".

(c) In any event, the CMA has overstated the extent of the advantage that providers of IC services enjoy when it comes to competing for FM business.

(i) Based on the CMA survey, only 47% of schemes buying FM first bought FM from their existing IC provider. This figure is even lower according to the analysis carried out by IFF research, which found that only 39% of trustee boards had appointed their incumbent IC provider at the time as their initial FM provider.[11] The CMA survey also showed that around half of the trustees surveyed received some form of third-party support (advice or tenders) when first entering FM.[12]

(ii) As discussed in the working paper on the competitive landscape, not all of the three largest providers of IC services are also the three largest providers of FM services. Therefore, it is clear that the perceived advantage of IC-FM firms has not restricted competition.

(iii) As acknowledged by the CMA at paragraph 71 of the Working Paper, a firm's success rate in tenders is not linked to the scale of its existing client base. Therefore, it is clear that any perceived advantage of IC-FM firms does not limit competition.

1.12 With regard to incumbency advantage generally, the CMA has stated that "larger, more established firms active in other services are more readily able to win new clients and that this pattern is likely to be even greater for FM".[13] This is based on the CMA's observation that it is more likely that a firm would be invited to participate in a tender process should it have an existing relationship.[14] The conclusion drawn is incorrect on two levels. First, as the CMA has acknowledged, the success rate in tenders is not linked to the number of tender processes participated in or the scale of any existing client base.[15] The tender success rates should be the focus of the CMA instead of the rate of participation in tenders. Second, as explained above, the advantage of IC-FM firms in relation to the provision of FM services has been greatly overstated.

1.13 The Working Paper briefly considers whether "perceptions of conflicts of interest" may create a barrier to expansion into FM for firms who already provide IC services to the client in question.

(a) This is not a barrier that we recognise on the basis of our own experience of offering both IC and FM services.

(i) We believe that it is entirely legitimate for an IC provider to advertise its FM services to its existing clients as long as the IC provider believes that (a) these services would

[11] See paragraph 1.8(d) for an explanation of the difference between the CMA analysis and that carried out by IFF research.

[12] Paragraphs 57, 58 of the Working Paper.

[13] Paragraph 74 of the Working Paper.

[14] Paragraph 72 of the Working Paper.

[15] Paragraph 71 of the Working Paper.

be beneficial to its clients and (b) does not purport to act as an independent and objective assessor of different FM services.

(ii) To the extent that clients are uncertain of the completeness of the information that their incumbent IC provider is providing to them about the relative value of their FM service, this can be readily addressed by running a competitive tender. As mentioned in our response to the trustee engagement working paper, in WTW's experience, competitive tendering is prevalent in FM and has increased materially over recent years. There has also been a significant increase in the use of intermediaries to assist clients in carrying out a competitive tender process.

(iii) As noted above, competitive tenders of this type are standard practice for clients transitioning from IC to FM. An incumbent provider of IC services would therefore be taking a significant risk in suggesting that its clients consider transitioning to FM services unless it were confident that it was in the client's best interest and that it stood a good chance of winning a competitive tender.

(b) As we have explained in previous submissions, we do believe that conflicts of interest play a role in preventing suppliers from expanding their FM service offering. However, this is the opposite source of conflict to that suggested by the CMA – namely that incumbent IC-only providers, who do not themselves provide FM services, have no incentive to inform clients about the benefits that these services can create.

(i) We are concerned that, as a result of this, many smaller pension trustees with limited bandwidth and expertise (who often stand to gain most from transitioning from an IC to FM service) may have little or no awareness of these potential benefits of FM.

(ii) We have flagged this concern in a number of previous submissions to the CMA, and are surprised that this issue has not been explored further by the CMA.

1.14 Alongside considering perceptions of conflicts of interest, the Working Paper also briefly considers whether firms which "bundle" services may have a competitive advantage when it comes to competing for FM business.

(a) The CMA does not list any services that could be bundled with either IC or FM in this regard – indicating that the CMA's thinking here is purely hypothetical rather than being based on any specific evidence.

(b) To the extent that some clients prefer to purchase both IC/FM and actuarial services from the same provider (e.g. for the sake convenience), this clearly does not present an insurmountable barrier to entry or expansion – as demonstrated by the fact that a number of successful IC and FM providers do not offer actuarial services.

WILLIS TOWERS WATSON

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