INVESTMENT CONSULTANCY SERVICES AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

COMBINED RESPONSE TO CMA WORKING PAPERS: (I) COMPETITIVE LANDSCAPE; AND (II) BARRIERS TO ENTRY AND EXPANSION

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CMA WORKING PAPER ON COMPETITIVE LANDSCAPE
CMA WORKING PAPER ON BARRIERS TO ENTRY AND EXPANSION

COMBINED RESPONSE FROM AON

INTRODUCTION AND SUMMARY

Aon welcomes the opportunity to respond to the CMA's Working Papers on the competitive landscape ("**CL WP**") and also on barriers to entry and expansion ("**BE WP**") both dated 26 April 2018. Because the subject-matter of these two papers is closely inter-related, we respond to them in a single submission.

In summary, Aon's response is that an absence of concentration, a lack of material barriers to entry or expansion, sustained and regular market entry over the last 10 years, and the existence of a wide range of providers offering differentiated service attributes are characteristics of a market with a healthy level of competition. We see no basis to support the finding of an AEC.

The CMA's findings reflect both our experience in the market and our submissions to the CMA during the course of this market investigation. As explained in our Issues Statement response, our site visit and our hearing, we face intense and continual pressure from vigorous competitors in both IC and FM. We operate in a dynamic market which has seen rapid expansion and sustained market entry. This competitive environment drives us to provide the highest quality service to our clients at competitive fee rates.

The findings in these two working papers further support our contention that the CMA's emerging findings provide <u>no basis whatsoever</u> for the CMA to consider far-reaching structural separation remedies. By continuing to maintain such remedies as a possibility, the CMA's actions are having a damaging and chilling impact on competition in the sector. They are affecting customer choice and hindering market entry and expansion.

In particular:

1. **These working papers provide <u>no</u> evidence to support the CMA's suggested theory of harm that barriers to entry and expansion reduce competitive pressure on investment consultants**.

   - The CMA's emerging findings clearly demonstrate that the IC and FM segments are competitive and neither is highly concentrated. In both IC and FM, the largest player holds a share of no greater than 20% and new entry has occurred almost every year since 2007.
   - The CMA's findings confirm that there is no "Big 3" in either segment. Continuing to characterise Aon and its competitors using such a narrative is not justified by the evidence and is misleading.
   - The strong existing competition in the IC and FM segments is enhanced by the absence of material barriers to entry or expansion for both IC and FM.
   - Other providers have, and future providers can, use their reputation, systems, know-how and regulatory compliance from operating in adjacent sectors to enter and expand into IC and FM. Any capabilities required to launch services in a segment can be readily purchased from third parties. There is no indication that these features will change. Entry

and expansion can be expected to continue once the uncertainty of the market investigation subsides.

2. **The CMA's contention that the three largest IC firms "*could continue to collectively gain market share*" in FM is entirely speculative**

- Whilst we compete hard for new customers and aspire to grow our FM revenues, other competitors want to do the same. The market is expanding and so is the number of competitors. This means that no provider is able to guarantee continued growth of share.
- Even if Aon's and other providers' share of FM services were to continue to grow, the CMA has not presented any evidence as to why this would lead to an AEC.
- Aon does not agree that it could have an unfair incumbency advantage in securing FM customers. Our clients are experienced buyers. The proportion of schemes that purchase FM after a tender, or following third party input, continues to increase, which mitigates against any opportunity to take advantage of existing relationships. While, as is the case in nearly all professional services firms, cross-selling can take place (and only if in the client's best interests) this does not equate to clients being 'steered' towards FM.
- A rapidly-expanding FM segment also means that there are opportunities to grow customer relationships, expand experience and boost revenues for all providers, not just those who hold a stronger position in IC.

3. **The competitive environment that the CMA has observed in both IC and FM is enhanced by the strong linkage between them**.

- The strong links between the provision of IC and FM has encouraged innovation, has provided pension schemes with choice and has provided them with confidence to move into FM. This has allowed a range of providers to enter the market, providing competition to IC providers, and ensuring competition in FM.

4. **There is no evidence to support the CMA adopting far-reaching structural remedies. If an AEC were to be found, structural remedies would be wholly disproportionate and would materially endanger the future competitiveness of IC and FM**.

- Structural remedies would not be effective. They would not address any perceived incumbency advantages which could arise in other adjacent services beyond IC. Similarly, they would not address perceived conflicts of interest since IC-only firms are subject to other conflicts which can lead them not to recommend FM even when it could be in their clients' best interests.
- Critically, if IC and FM services were to be provided by separate firms, customers would experience a reduction of available products and a reduction in the number of IC and FM firms available to them. The cost of providing FM would be raised considerably by removing economies of scope across IC and FM services. Competition, and the potential for entry and expansion, would be reduced and not enhanced.
- The focus of any remedies should be on empowering pension trustees to better exploit the competitive opportunities that are already fully open to them.

1. THE WORKING PAPERS PROVIDE NO EVIDENCE TO SUPPORT THE SUGGESTED THEORY OF HARM THAT BARRIERS TO ENTRY AND EXPANSION REDUCE COMPETITIVE PRESSURE ON IC AND FM FIRMS

1.1 The CMA's emerging findings clearly show that there is a competitive landscape with respect to both IC and FM. This fully reflects our experience in the market. The evidence does not support a finding that high barriers to entry and expansion reduce competitive pressure. Indeed, we face constant pressure from a broad range of competitors in both IC and FM and the number of competitors we face in each segment is growing continuously.

The IC segment is competitive; barriers to entry and expansion are low

1.2 Aon agrees with the CMA's emerging finding that the IC segment is not highly concentrated (CL WP, 5) and is becoming less concentrated over time (CL WP, Fig. 9). It is clear that <u>no firm has market power as a provider of IC services</u>:

1.2.1 There are many well-established firms competing across all segments – the largest IC provider having a share no greater than 20% (CL WP, 5).

1.2.2 New entry occurs almost every year, with 12 new entrants since 2007 (BE WP, Fig. 1).

1.2.3 Smaller schemes have a very wide choice of supplier, including wealth managers, independent financial advisors and actuaries (CL WP, 30). The largest schemes also have substantial choice and exercise buyer power through their in-house expertise, use of external consultants for more limited pieces of project work, and ability to employ multiple consultants simultaneously (CL WP, 6, 37).

1.2.4 Almost all ICs from which the CMA obtained service level data are able to offer advice across the full range of services and there remain a significant number of options for clients seeking advice of each type (CL WP, 94-95).

1.3 The CMA finds that barriers to setting up a new IC firm are not "*prohibitively high*" (BE WP, 10); that expansion can be facilitated by high rates of switching (27% within the past 5 years); and that there is the opportunity for smaller less-well known firms to develop relationships through providing ad-hoc and discrete pieces of advice.

1.4 In light of these market dynamics, the CMA must conclude that the supply-side of the IC segment is functioning well.

The FM segment is competitive

1.5 We also agree with the CMA's emerging finding that the FM segment is not highly concentrated (CL WP, 7) and that customers have access to a "*sufficient number of suppliers*" (CL WP, 7). As with the IC segment, the evidence demonstrates that <u>no firm has market power as a provider of FM services</u>:

1.5.1 There are five large firms competing across all segments, the largest share being just 17% (CL WP, 5, Fig. 10). There is no 'big 3' [✂].

1.5.2 Several other rivals which the CMA describes as "*significant players in their own right*" are also present, including BlackRock, Cambridge Associates, Cardano and

SEI Investments (CL WP, 119) such that no less than 18 players compete in this segment. Aon expects this figure to grow further.[1]

Barriers to entry in FM are low

1.6 We note that the CMA finds that barriers to setting up a new FM firm or service line are not "*prohibitively high*"; our view is that they are in fact low. We agree with the CMA that there are no natural or intrinsic factors that act as a significant barrier to entry (BE WP, 22). This is amply demonstrated by the fact that new entry has occurred almost every year since 2007, with 12 entrants over the period 2007-2016 (BE WP, Fig. 1). Many entrants are of significant size and sophistication and have the reputation and resources to drive meaningful entry and expansion. We fully expect this trend in FM to continue.

1.7 We also agree that it is possible for new entrants to overcome the requirement to fund and develop a research capability, as evidenced by the varying sizes and capabilities of new entrants into the FM segment. It would not be meaningful for the CMA to seek to determine a minimum research capability or team size since a research capability can be delivered in a wide variety of ways, including by purchasing data or growing a research team in tandem with client requirements.

1.8 Higher costs and greater economies of scale in FM compared to IC are not as great a barrier to entry as the CMA has indicated:

1.8.1 Successful provision of FM services does not <u>require</u> a firm also to provide IC services. This is evidenced by the several recent entrants from the AM sector (e.g. Schroders; SEI; BlackRock; Charles Stanley; Kempen).

1.8.2 While platform and regulatory costs may be greater for FM operations than IC operations, many firms that enter the FM segment will be able to adapt existing platforms, and will already be well-used to addressing regulation. They need not offer the full range of FM services at launch.

1.8.3 Discounts from asset managers can be more attractive for larger-scale FM operations. However, discounts do not need to be earned simply in FM. Investments made with asset managers in the context of IC activities can also count towards FM fee discounts. This facilitates a move into FM by any IC firm.

Barriers to expansion in FM are not material

1.9 While the CMA notes that barriers to winning clients are potentially greater than setting up an FM firm, we do not consider that barriers to expansion are material. This is demonstrated in particular by the substantial growth in the past three years of three of the top five FM providers.

1.10 With respect to brand recognition and reputation, the CMA states that: "*We have heard from several parties that a pension trustee will often prefer to choose a large, well-recognised*

[1] We also note that substitutes to FM services exist as noted by the CMA: "We understand that there are a number of asset management services which can fulfil a similar role (in some respects) to FM itself. As a consequence, schemes which purchase services outside the definition for FM may nevertheless consider themselves to be *in effect* purchasing such services" (CL WP, fn25).

brand on the grounds that 'no-one ever got fired for choosing IBM'" (BE WP, 43). This point should not be overplayed.

1.11 There are many well-established FM firms and many more asset managers or IC providers that have solid reputations and are well-known to trustees, as the CMA has recognised: *"a number of the smaller players and recent entrants in the FM market are part of very large firms in other markets, which implies that they are likely to be relatively well resourced and have a degree of established reputation*" (CL WP, 145; see also BE WP, 47).

1.12 Differences in the importance of brand recognition or reputation to pension schemes of different sizes should not trigger competitive concerns. Smaller schemes can be served by a variety of smaller FM service providers who do not require a leading reputation to secure a mandate. Larger, better-resourced schemes may opt for the "IBM" option but they do that as sophisticated purchasers with demanding requirements and strong countervailing buyer power.

1.13 Moreover, trustees are well aware of the competitive landscape. The CMA's Trustee Survey found that professional trustees hold positions with, on average, 16 schemes, meaning that they have a good appreciation of the relative strengths of a wide variety of FM firms.

1.14 We agree with the CMA that customer acquisition costs are "*not prohibitive*" (BE WP, 40). We also often find that trustees invite a range of firms to tender, such as one small, focussed or niche player, one mid-sized player and one large player such as Aon. [✂]often by emphasising a perceived ability to be more nimble or offer a more individualised service. These smaller providers can gain experience and market reputation serving these customers or by providing ad-hoc and discrete pieces of advice before expanding to serve larger customers.

1.15 The largest schemes can and do exercise buyer power in order to sponsor expansion, making use of sophisticated trustees and staff to engage providers for more limited pieces of project work, or employing multiple consultants simultaneously.

2. THE CMA'S CONTENTION THAT THE THREE LARGEST IC FIRMS "COULD CONTINUE TO COLLECTIVELY GAIN MARKET SHARE" IN FM IS ENTIRELY SPECULATIVE

Future share growth of the three largest firms is not certain

2.1 We see no basis for the CMA's statement that the three largest IC firms "*could continue to collectively gain market share* [in FM] *in the foreseeable future"* (CL WP, 9).

2.2 First, as the CMA itself indicates, this is just a "*possibility*" and one that is "*difficult to predict*".

2.3 Second, the CMA's evidence for future rising concentration is that Aon, Mercer and WTW "*have ambitious growth plans in FM*" (CL WP, 9). However, this simply demonstrates future vigorous competition in a growing segment among firms without market power. As in all industries, not all firms will achieve their aspirational internal 'stretch' targets. It is also likely that if growth plans of other competitors (many of which are part of sizeable financial services firms with the resources to expand) had also been examined, they too would indicate the same ambition to grow share.

2.4 The CMA claims that Aon, Mercer and WTW have in aggregate gained around 40 percentage points in share in the past ten years. This would mean that 10 years ago WTW and Mercer held a combined share of no greater than 4%, yet they (together with Aon who entered the segment in 2010) were able to grow rapidly. The CMA has also noted that due to this "*entry and subsequent rapid growth of the three largest IC providers"* (CL WP, fn62) the HHI for the provision of FM in fact fell substantially from 4300 in 2007 to 1353 in 2016. The leading firms in the segment could therefore credibly change again in the future.

2.5 Finally, the CMA indicates that the FM segment's overall size is expected to grow further (CL WP, 141). Entry and growth is normally considered to be easier in expanding markets, as set out, for example, in the CMA's Competition Act guidelines on Assessment of Market Power.[2] In particular, Aon considers it highly likely that segment growth will attract further new entrants after the uncertainty of the current market investigation dissipates.

The CMA overstates any incumbency advantage of the three largest IC firms

2.6 The CMA identifies in essence a single alleged incumbency advantage, namely the ability to secure initial access to a client because of an existing business relationship such as IC, actuarial, AM or other professional services. However, this does not amount to a material barrier to competitor expansion, in practice, due to several reasons.

Many providers have existing client relationships in adjacent markets

2.7 17 out of 18 existing FM providers offer services in adjacent markets and so are not disadvantaged. In many cases they will already have a commercial relationship with the tendering scheme. As the CMA has itself found, apart from Aon, Mercer and WTW (CL WP, Fig. 1):

- 7 FM providers also offer AM services;
- 3 FM providers also offer IC and AM services;
- 2 FM providers also offer IC and actuarial services; and
- One further FM provider also offers IC services.

Growth in tendering and third party advice increases rivals' access to customers

2.8 Access to new customers for all FM providers is enhanced by the wide use of tendering and third party advice, facilitating entry and expansion. For example, the CMA survey found that 70% of schemes purchasing FM services for the first time say that they ran a tender process.[3] The 2017 KPMG survey found that 60% of new FM appointments were advised by an independent third party (up from 33% the previous year) who would be expected to mitigate any alleged incumbency advantage (or information shortfall on the demand side).

2.9 The FM segment is still new, meaning that relatively few FM clients have yet reached a point at which a fundamental review of their strategy is required such as to potentially switch. As more schemes reach this point over the next few years switching is likely to increase.

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284400/oft415.pdf (paragraph 5.33).
[3] IFF Research report on survey, paragraph 5.18.

Success in tenders is not linked to any existing market power

2.10 The success of an incumbent at tender <u>does not</u> reflect an advantage based on market power:

2.10.1 First, the CMA admits that it has "*no evidence on the extent to which firms are invited to tender as a result of an existing client relationship*" (BE WP, 70) and that "*there does not appear to be a link*" between a firm's overall success rate in tenders, compared to the proportion of clients to whom it tendered with which it had an existing relationship (BE WP, 71). Whilst the CMA appears to suggest that firms with existing relationships are more likely to tender to serve their existing clients (BE WP, 72) seeking to offer a wider range of services to existing clients is standard business practice. It is neither an incumbency advantage nor a sign of market power.

2.10.2 Second, market power (for which the CMA has adduced no evidence) is not the same as an incumbent potentially having a better ability to serve a customer well – as evidenced by the CMA's finding that the greatest trustee satisfaction relates to the use of IC-FM firms). Where an IC provider has served a client well, it is often <u>rational</u> for that client to prefer to engage the same provider for FM services (e.g. when the client wishes to pursue its existing investment strategy but to obtain help in implementing that strategy).

2.10.3 Third, the CMA's survey shows that in any event the incumbent is not always successful in retaining existing IC customers when the customer first purchases FM. Only 51% say that they currently use an FM provider that was previously their IC provider.[4]

2.11 The CMA has suggested that some smaller FM providers might find it hard to access tenders (BE WP, 55). However, we always view new entrants as credible rivals, particularly if they have large, well-resourced existing operations in an adjacent segment. For example, [✂].[5]

3. THE COMPETITIVE ENVIRONMENT THAT THE CMA HAS OBSERVED IN BOTH IC AND FM IS STRENGTHENED BY THE STRONG LINKAGE BETWEEN THEM

3.1 While it is helpful to assess market structure, new entry and the demand side of the market separately in respect of IC and FM services, it is important not to lose sight of the fact that there are important features, highly beneficial to customers, that link these sectors. In fact, competition in both the IC and FM segments works more effectively *because* of these links.

3.2 As set out in our response to the WP on the supply of FM by IC firms, trustees often see IC and FM as substitutes because the services materially overlap. A move from IC to FM can be part of an evolving trustee strategy under which the client's investment strategy formulated when they were an IC client can continue if they opt to move into either partial, or

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[4] IFF Research report on survey, paragraph 5.13. (A higher percentage buy FM services from their current IC provider suggesting that the customer had either switched IC or FM provider, or both since first appointing an FM provider, paragraph 5.14.)

[5] Aon's response to question 72 of the Market Questionnaire.

full, FM. This is possible because the same intellectual capital underpins both services – only the mode of delivery differs.

3.3 The overlap between IC and FM services is also reflected in the significant proportion of elements that are common to the provision of both services such as support functions (BE WP, 23); manager and asset allocation research functions (BE WP, 24); risk asset liability modelling; operational due diligence; customer relationships, brand and reputation; infrastructure costs; and more.

3.4 Trustees who are content with their current investment advisor but seek assistance implementing their investment strategy would therefore be entirely rational to consider their current IC provider as a good candidate for the supply of FM services.

3.5 Any IC provider would naturally be well placed to enter the FM segment (as shown by the fact that ten providers already offer both IC and FM services (CL WP, 68)). Moreover, once the uncertainty caused by the on-going market investigation is resolved, Aon fully expects further entrants to join the FM segment.

3.6 By contrast, we do not recognise the CMA's concern (BE WP, 79) that IC providers may be unwilling to expand into FM for fear of losing clients who would consider them to be conflicted. Our experience is that trustees value and encourage the additional options that are available to them by being able to purchase both IC and FM services from a single firm.

4. THERE IS NO EVIDENCE TO SUPPORT THE CMA ADOPTING FAR-REACHING STRUCTURAL REMEDIES. IF AN AEC WERE TO BE FOUND, STRUCTURAL REMEDIES WOULD BE WHOLLY DISPROPORTIONATE AND WOULD MATERIALLY ENDANGER THE FUTURE COMPETITIVENESS OF IC AND FM

4.1 None of the CMA's findings offer any conclusive evidence which would support the finding of an AEC in relation to barriers to entry and expansion for either IC or FM. However, to the extent that the CMA disagrees with the evidence and finds an AEC, the focus of remedies should be in enhancing competition by providing information to trustees to allow them to better exploit the competitive opportunities that are already open to them.

4.2 We could not, under any circumstances, support measures prohibiting existing IC firms from providing FM services. Such a measure would not effectively address perceived incumbency advantages and would fail the CMA's core tests for proportionality.

4.3 It would not be effective in its aim of eliminating the role of incumbency (to the extent it exists) in FM tendering because FM firms that have relationships with customers in other adjacent spheres would not be addressed by this remedy.

4.4 Other less onerous measures could achieve the same aim and in fact be more effective. Potential conflicts can be (and are) well managed through other means. Moreover, measures to encourage the provision of comparable information to trustees, allowing them to better exploit the competitive opportunities already open to them, would be more effective that an enforced separation remedy.

4.5 A separation remedy would produce considerable disadvantages disproportionate to its aim - causing significant harm to IC-FM clients:

4.5.1 Barriers to entry in FM would increase: the cost of providing FM would be raised considerably by removing economies of scope across IC and FM services, because all of the elements listed in para 3.3 above would need to be duplicated. In addition, over 25 operators that the CMA has identified as offering IC but not FM services (CL WP, Fig.1) would need to divest/close their IC operations before they could enter FM.

4.5.2 Clients would be harmed by the removal of a significant degree of product choice: for example, all-in-one partial delegation packages would no longer be available. Clients could not retain the FM services of a valued IC to implement an investment strategy that they had developed with that advisor. Customers might be reluctant to move into FM, even if beneficial to them, if they could not retain their current advisor.

4.5.3 Clients would experience a reduction in the number of IC and FM providers available to them: if firms were obliged to separate their IC and FM services, it is likely that some would sell either their IC or FM client book (potentially to a competitor) rather than separate their businesses into two. Other firms might determine that the only way to remain competitive would be to merge with a fellow IC or FM provider. This would reduce the net number of IC and FM providers.

4.5.4 Clients would be disadvantaged by conflicts of interest emerging: they would be required to navigate new conflicts of interest inherent in the fact that IC-only firms would not be incentivised to recommend FM (because a customer that switched to FM services would likely require fewer services from the IC-only provider). Also, FM-only firms might use in-house funds rather than independent highly-rated funds as we do today.

4.6 It is also important to recognise that the mere fact that a separation remedy is being considered by the CMA is causing significant damage to the FM segment now. New entry into the segment has paused since the launch of the CMA's investigation. Existing competitors are likely to have halted expansion because of the uncertain investment environment that the CMA has created.

4.7 Equally, as we have seen in a recent 'request for proposal', customers may be reluctant to engage with an FM firm, or they may be advised by a TPE that there is risk in appointing an FM firm. This is due to a fear that the appointed firm will be obliged by the CMA to exit the segment, leading to costs as the customer later re-invests with a different FM.

4.8 Until the CMA makes a clear declaration that this remedy will be excluded from its considerations, customer choices in the purchase of FM will continue to be restricted, and competition will continue to be damaged.