INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

RESPONSE TO WORKING PAPER ON FINANCIAL PERFORMANCE AND PROFITABILITY

---

10 MAY 2018

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

WTW RESPONSE TO WORKING PAPER ON FINANCIAL PERFORMANCE AND PROFITABILITY [1]

1.1 WTW welcomes the opportunity to respond to the working paper on "financial performance and profitability" published by the CMA on 26 April 2018 (the "**Working Paper**"). In what follows, we first comment on the Working Paper's overarching findings with regard to the profitability of IC and FM services. We then set out and explain our views on the specific areas on which the CMA has invited comments.

2. Comments on the Working Paper's overarching conclusions

2.1 The CMA notes that it has not been possible to conclude whether IC and/or FM profits are in excess of cost of capital, on the basis of the practical and conceptual difficulties associated with measuring the total capital employed relating to IC and FM businesses. We agree with this conclusion for the reasons that the CMA has set out in the Working Paper. As we explained in our response to the Financial Information Request, the difficulties that the Working Paper has identified apply to WTW:

(a) It is not clear how one could obtain an IC or FM service-level measure of capital employed from the overall value for the WTW business.[2] WTW does not have separate balance sheets for its UK IC and UK FM businesses. The Working Paper is correct to note that it would be a highly demanding and resource-intensive exercise to create these service-specific balance sheets. The costs and effort involved would be disproportionate and the exercise would almost certainly fail to yield reliable or useful results.

(b) In any event, even looking at WTW's business as a whole, the available measures of capital employed would not be appropriate for an economic profitability analysis, since they would not include the relevant intangible assets that account for a substantial proportion of the assets in this sector.[3] Again, the CMA is right to conclude that the challenges of quantifying these intangible assets would be disproportionately high. For the reasons we explained in our response to the Financial Information Request, it is highly unlikely that such an analysis would be capable of generating a robust estimate of the size of capital base of an IC or FM firm in any event.

2.2 As the Working Paper also recognises, profitability is not a "feature of the market" for the purpose of the CMA's AEC test and analysing profitability will provide no clear evidence as to whether the market could be more competitive[4] – particularly in the absence of a meaningful capital base against which to measure these profits. In light of this, it would be more productive for the CMA to focus on directly appraising the theories of harm it has set out in its Statement of Issues, rather than diverting further resources and effort into an assessment of industry profitability that will provide no useful insights into these theories of harm.

2.3 The CMA also concludes that the effort required to undertake an analysis of economic profitability with reference to capital employed would be disproportionate "*given that detriment could arise from*

[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] See paragraphs 4.3 and 4.4 of the FIR response.
[3] See paragraphs 4.5 – 4.9 of the FIR response.
[4] Working Paper paragraph 19.

low quality advice provided by IC or FM providers resulting in poor investment decisions by pension schemes."[5] We agree that profitability analysis would provide no insight into this issue. The CMA has not yet carried out a systematic assessment of quality of advice (or quality of service more widely) in any of the other working papers it has published to date. We provided a detailed submission to the CMA in January 2018 that described how the CMA could undertake such an analysis, and which presented evidence to substantiate and quantify the value that our FM and IC services create for clients.[6]

3. Specific issues on which the CMA has invited comments

3.1 The CMA indicated, in paragraph 7 of the Working Paper, that it would welcome views on four specific issues. All of these issues focus on the question of whether there may be other ways of estimating any potential detriment in the industry in the absence of an economically meaningful measure of the return on capital employed (ROCE) of IC and FM firms. We do not believe that a comparison of profit margins, or any other profitability measure comparison considered, will yield an informative conclusion about potential detriment in the industry. The profitability metrics that WTW calculates and monitors for its own internal purposes can be used to monitor trends in margins over time and compare margins across different services. However, the value of any industry comparisons is limited since – as explained in previous submissions to the CMA – margins can vary widely across services and over time for reasons that have nothing to do with differences in levels of competitive pressure.

3.2 We provide further observations to each of the areas for comment identified by the CMA below.

(a) Identification of any suitable industries against which to benchmark IC and FM profit margins.

(i) Profit margins can be informative when considering trends over time, or when comparing different providers within the same sector. However, properly benchmarking IC or FM profit margins against the profit margins of other industries is a challenging and resource-intensive exercise.

(ii) To be confident of the appropriateness of any benchmarks, one would need to confirm that the sectors in question:

(A) had similar levels of capital employed to IC and FM;

(B) faced similar levels of risk – and therefore had a similar cost of capital – to those faced by IC and FM providers;

(C) were at a similar stage of development (for example, firms in new industries or industries undergoing rapid transformation may not yet have reached efficient scale and/or may be sacrificing short-run profits for longer-term returns); and

(D) have not been affected by economic shocks that could temporarily distort levels of profitability (e.g. a downturn in demand for the industry's services, which might temporarily depress profits).

[5] Working Paper paragraph 4.
[6] See, for example, the analysis of our FM track record in the Performance Measurement paper submitted to the CMA on the 16th of January 2018.

(iii) This would be a highly challenging and resource-intensive exercise to undertake properly, and – just as for a ROCE-based analysis – the effort required would not be proportionate. We note that the CMA (and its predecessor the Competition Commission) reached similar conclusions about the limited value of this type of analysis in previous market investigations into service-sector industries, including statutory audit services, retail banking and the energy retail sector.

(b) Views on whether these profit margins appear to be high and whether there are particular factors which explain this.

(i) In the absence of a relevant benchmark (i.e. either a benchmark constructed on the basis of a bottom up assessment of cost of capital and capital employed, or a top-down benchmark based on industries with the characteristics listed in paragraph 3.2(a)(ii) above and where competition is known to be functioning well), it is impossible to reach any direct conclusions about whether profit margins for IC and FM providers are "high" in the sense of exceeding the level required to cover their cost of capital.

(ii) Nonetheless, WTW does not believe that its profit margins are any higher than necessary in this sense. WTW continually faces strong competitive pressure and the margins it earns are those which allow it to support continued investment in the high quality of service required to attract and maintain customers

(c) Identification of any further suitable profitability metrics, such as revenue per client.

As set out in our response to the CMA's Financial Information Request, there are a number of profitability metrics that WTW uses in the normal course of business. These metrics can be useful in tracking trends in the performance of different parts of WTW's business over time. However, in the absence of any appropriate benchmarks, these metrics cannot be used to form any views about the existence or otherwise of "excessive profits" for the reasons explained above.

(d) Given that we have not conducted a return on capital employed (ROCE) analysis, views on whether we should estimate any potential detriment.

As noted above, we strongly believe that it would be more productive for the CMA to focus on directly appraising the theories of harm it has set out in its Statement of Issues, rather than diverting further resources and effort into an assessment of industry profitability that will provide no meaningful measure of detriment – and yield no useful insights into the theories of harm that the CMA is exploring.

WILLIS TOWERS WATSON

10 May 2018