INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

WTW RESPONSE TO THE EVIDENCE PRESENTED TO DATE

8 JUNE 2018

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1. Introduction

1.1 WTW[1] welcomes all the work completed by the CMA so far in the course of this market investigation. Having now reviewed and responded to the full set of Working Papers, WTW considers that it would be helpful to take a step back and review the state of the complete evidence base that the CMA has available to it, and to understand where this might leave the inquiry. In WTW's view:

(a) As a whole, the evidence base available to the CMA – consisting of the analysis in the Working Papers and third party responses to these, the trustee survey and the content in the summaries of the roundtables held by the CMA – supports the view that the market is competitive and clients are very satisfied with the services being provided.

(b) There is very limited evidential support for the Theories of Harm set out in the Statement of Issues.

(c) Instead, WTW considers that the main challenges faced by pension fund trustees relate to limited trustee bandwidth/expertise and industry fragmentation faced by pension schemes. However, the CMA has not fully explored the value added by market-driven solutions to these issues, in particular through the introduction of fiduciary management (FM).

- As WTW has previously submitted, the FM service has had a proven track record of delivering lower levels of risk and higher average returns than those of the average UK DB scheme. The CMA has not challenged the evidence WTW has provided on these factors.
- Both of these elements – risk reduction and returns – add substantial value to pension fund trustees and sponsoring employers. Below, we demonstrate that if a greater proportion of schemes had taken up FM solutions in recent years, the benefits to trustees and sponsoring employers from a risk reduction perspective alone could have run into at least hundreds of millions of pounds annually.
- We continue to encourage the CMA to engage with an assessment of the benefits of FM and of the barriers that may be limiting the take up of FM and causing significant detriment to pension schemes. We believe that these barriers are preventing a significant number of pension trusts from taking up the service, even though they would benefit from doing so. However, such are the benefits of FM that even if these barriers had only prevented a small proportion of schemes from taking up the service, they would still constitute a significant adverse effect on competition (AEC).

(d) Some of the remedies put forward by the CMA through the Working Papers could be helpful for the industry, but others would be ineffective, disproportionate and/or potentially harmful for pension schemes and their members.

2. The analysis presented in the Working Papers supports the view that the market is competitive and clients are very satisfied with the services being provided

2.1 In WTW's view, the evidence presented in the Working Papers, taken together, paints the picture of a market that is competitive and where clients are satisfied with the services they receive. As noted below, this is confirmed by the findings of the CMA's survey.

[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.

The evidence points to a market with healthy levels of competition

2.2 High level structural indicators point to healthy competition both in IC and FM:

(a) There are many players in the industry – there are 32 players in IC and over 18 in FM.[2]

(b) No "dominant" firms exist in the industry – no firm has more than 20% market share and the largest three have less than 50%[3].

(c) Largest firms are not immune to competition – out of largest three in IC, one has seen a sharp decline in its market share and not all have been able to achieve the same position in the FM market.[4]

(d) Low levels of concentration which has declined in the last decade – the Herfindahl-Hirschman Index ("**HHI**") for the IC Market is 1,023[5] and for the FM Market is 1,324[6]. Both of these measures are well below the threshold of 2,000 set by the CMA for the market to be considered highly concentrated.

2.3 There are no significant barriers to entry:

(a) There are no material barriers to entry for either IC or FM – the main cost communicated by the CMA is building up research capabilities. However, different business models with less focus on research allow firms to enter without this cost, e.g. firms initially acting as a niche provider, and then expanding areas of expertise.

(a) Reputation matters but there are many ways to establish a reputation, e.g. breaking away from an existing provider, or having complementary skills (such as asset managers entering FM).

(b) The CMA has noted the very high levels of entry of firms into both the IC and the FM industry. There have been 12 new entrants in both cases over the last ten years.[7]

2.4 The CMA has found no evidence of excess profitability as described in its Financial Performance and Profitability Working Paper.

The survey and summaries of roundtables show that trustees are happy and satisfied

2.5 The CMA's survey paints a positive picture of the state of the market. Overall, trustees surveyed were highly positive about the services they receive, whether IC or FM is considered. For instance:

(a) 95% of trustees using IC services rated the service positively – "Over half of trustee boards using IC services (57%) are 'very satisfied' with them, and almost all of the remainder are 'fairly satisfied' (38%)."[8]

(b) 95% of trustees using FM services rated the service positively – "Over half of trustee boards using FM services (59%) are 'very satisfied' with them, and almost all of the remainder are 'fairly satisfied' (36%)."[9]

(c) 97% of trustees thought that their provider was "very important" or "fairly important" to meeting their objectives.[10]

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[2] Paragraph 68 of the Competitive Landscape Working Paper.
[3] Paragraph 5 and 7 of the Competitive Landscape Working Paper.
[4] Paragraph 28 of the Financial Performance and Profitability working paper.
[5] Paragraph 77 of the Competitive Landscape Working Paper states an HHI of 1,023.
[6] Paragraph 147 of the Competitive Landscape Working Paper states an HHI of 1,324.
[7] Figure 1 of the Working Paper on Barriers to Entry and Expansion.
[8] Page 14 of the IFF Research's report of the survey commissioned by the CMA (CMA's survey).
[9] ibid

2.6 Within the summary of the roundtables that the CMA had with a number of trustees, there was evidence of trustees being satisfied with the services that they receive. For instance, "trustees valued the quality of advice from their consultants in both FM and IC. Trust in, and credibility of, their main adviser were important themes across trustees for both DC and DB schemes".[11]

2.7 Trustees were asked in the survey which features of the service they consider "very important". The responses make it clear that, while increasing returns is one relevant concern for trustees, it is not the only or even the most important way in which providers add value. For example, for IC services "bringing in expertise that trustees do not have" was considered important by 85% of respondents, and "reducing / managing risk" was considered important by 72%, in comparison to the 49% of respondents that considered "increasing returns" important.[12] WTW considers that the CMA should take this wider focus of trustees into account when assessing the evidence on investment consultants' performance.

2.8 Trustees were also positive about the extent to which they find it easy to monitor the performance, fees and quality of service of their investment consultant, with between 85% and 95% of trustees considering these features were very or fairly easy to monitor.[13] A lower but still materially positive number (66%-74%) considered that it was very or fairly easy to monitor fees paid to third parties.[14]

2.9 Trustees did not report material barriers to switching.

(a) 82% of those switching provider found it easy to switch – Of those switching their main provider of advisory services, nearly half said they found the process 'very easy' (47%) and a third (35%) found the process "fairly easy".[15] [16]

(b) Of those who carried out a tender process (whether or not they eventually chose to switch), 82% found it "very easy" (31%) or "fairly easy" (51%) to identify the best investment consultancy for the scheme based on the proposals received.[17]

(c) Of all surveyed trustees who chose not to switch investment advisory provider in the last five years, 75% stated that this was because they were "happy with their current provider" and 8% stated that they "don't want to lose expertise built up by existing provider".[18]

(d) Only 11% of the trustees who chose not to switch investment advisory provider in the last five years stated that this was in order to "avoid time / effort / cost of tendering / switching".[19] This (prompted) response wraps together a number of quite distinct motivations – for example, the cognitive cost to trustees of assessing and comparing potential new providers, and the financial cost to the scheme of being transferred to a new provider.

3. There is at best limited support for the CMA's Theories of Harm as set out in the Statement of Issues

3.1 The CMA set out the following theories of harm in its Statement of Issues:

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[10] Page 13 of the IFF Research's report of the survey commissioned by the CMA (CMA's survey).
[11] Paragraph 39 of the Note of CMA roundtable discussions with pension trustees (1 & 2 May 2018).
[12] Figure 3.13 of the IFF Research's report of the survey commissioned by the CMA (CMA's survey)
[13] Paragraphs 72, 74 of the Trustee Engagement Working Paper.
[14] Slides 20 and 21 of Working Paper on Fees and Quality.
[15] Page 16 of the IFF Research's report of the survey commissioned by the CMA (CMA's survey).
[16] Note only those boards of trustees that purchase advisory services exclusively were asked questions about the switching process.
[17] 23% found it 'very easy' and 59% found it 'fairly easy'.
[18] Table I1 from IFF Research data tables, All scheme types, scheme-weighted (29.3.18).
[19] ibid

(a) Difficulties in customers' ability to effectively assess, compare and switch investment consultants result in weak incentives for investment consultants to compete for customers (Demand side and information issues).

(b) Conflicts of interest on the part of investment consultants reduce the quality and/or value for money of services provided to customers (Conflicts of interest).

(c) Barriers to entry and expansion reduce competitive pressure on investment consultants, which leads to worse outcomes for customers (Barriers to entry and expansion).

3.2 Based on the evidence presented to date in the Working Papers and the other sources reported by the CMA, WTW's view is that none of these theories of harm appears to be playing out materially in the market.

Demand side and information issues

3.3 In relation to demand side and information issues, WTW considers that the following conclusions can be drawn from the evidence:

(a) The majority of trustees are engaged (over 70%, even on the CMA's restrictive measure of engagement). Trustees feel equipped with the necessary information to do their job effectively – they feel able to monitor the service they receive, have the information to do this, are able to make assessments about cost and quality during tenders, and that the switching process is easy.

(b) The clarity and comparability of information is generally good, as perceived by trustees, with the exception of third party fees where most trustees still consider the information easy to monitor but we agree that there is scope for improving the clarity of information.

(c) There are no barriers to switching and tendering other than inherent cost, while the vast majority of trustees stated in the survey that both activities are easy.

(d) The CMA has not put forward any evidence that information is presented in an overly complex way, or that providers artificially increase the complexity of the investment strategy, in order to inflate cost or reduce their clients' ability to make price comparisons or switch providers.

(e) The analysis on gains from engagement, which focused exclusively on service fees, found no impact of switching and at best weak results for the CMA's measures of engagement (which exclude customers who didn't switch providers when taking up FM). The analysis of engagement does not appear to be statistically robust, although WTW's ability to comment on this is limited as the CMA has not shared the analysis with the Parties.

3.4 Overall, WTW submits that the CMA has not found any robust evidence that demand side issues are leading to worse outcomes for pension schemes.

Conflicts of interest

3.5 WTW does not consider there is any evidence of a material conflict of interest.

(a) The CMA has presented certain aspects of its analysis as apparently supportive of the theory of harm that incumbent IC providers are "steering" trustees towards in-house FM services. However, the evidence simply indicates that IC-FM providers attempt to cross-sell by mentioning the existence of other services they offer, a practice that does not give rise to a conflict, nor is it anti-competitive.

(i) For example, in the survey trustees were asked whether their IC provider mentioned their own service when first discussing the option of FM. In WTW's view, this cannot be considered to be a conflict of interest, otherwise all multi-product firms that have a relationship with a client based on one service would be conflicted in ever mentioning other services they offer.

(ii) In order for there to be an actual conflict, in WTW's view, the IC provider would have to be holding itself out as acting as an "independent advisor" in the selection process for FM services. This is a fundamentally different situation from merely mentioning the existence of the in-house service. The CMA has not provided any evidence to suggest that such behaviour is occurring.

(iii) WTW also notes that prohibiting the incumbent IC provider from mentioning or tendering for the supply of FM services to its own IC clients would restrict clients' choice and be clearly anti-competitive.

(iv) Indeed, there would be a danger of damaging innovation in the industry if providers were discouraged from developing new products because of an apparent "conflict" (the perception of which is perhaps encouraged by single-product firms who have not engaged in the same innovation).

(b) The CMA presented two other theories of harm in the Statement of Issues relating to conflicts of interest: that outside business relationships with asset managers affect the independence of investment consultants' advice and that the receipt of gifts and hospitality affect the independence of investment consultants' advice. The CMA has not presented any evidence supporting these theories of harm so far in the investigation, nor would we expect there to be any.

(c) Other third parties have also pointed to the lack of evidence of an AEC relating to conflicts between IC and FM or any related detriment. For example, see:

(i) Aon's response to the Working Paper on the supply of fiduciary management services, paragraph 3.12.3.

(ii) Mercer's response to the Working Paper on the supply of fiduciary management services, paragraph 5.3(a).

Barriers to entry and expansion

3.6 As set out above, there is very strong evidence that there are no significant barriers given the frequency of entry (and expansion) into both the IC and FM markets over the last decade.

3.7 With regard to the CMA's contention that reputation - or lack thereof - may act as a barrier to expansion in FM, WTW acknowledges that it can take time to establish a strong track record in the provision of FM services. Having said that, 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, the ability to develop such a track record is demonstrably not an insurmountable barrier to successful entry or expansion.

3.8 Additionally, 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.

3.9 In summary, WTW does not consider that the CMA has found any clear evidence of any of its theories of harm, and has not found any quantifiable detriment in the market.

4. The CMA should focus on the main challenges faced by pension schemes and trustees, and identify ways to unlock the full potential of solutions provided by the industry

4.1 As WTW has previously submitted, while many trustees are highly committed and take their role very seriously, some can face difficulties given the complex nature of investment services and their limited experience or resources to deal with their activities as board trustees. Often they do not have a professional background in institutional investing and many have limited time and resources to process all the information and make all the necessary investment decisions for the scheme. The asset management industry is continually developing new products and solutions, providing benefits to trustees, but this also means there is growing complexity and a need to stay abreast of all the changes. Investment conditions may change rapidly, requiring trustees to be responsive to changes in the market environment at short notice. In addition, under the advisory model trustees have to confirm all the manager selections and carry out portfolio execution (which is extremely time consuming).

4.2 Therefore we agree with the CMA that a full understanding of the demand side issues is crucial. Our view is that many of the observed behaviours that the CMA appears to find potentially problematic are driven by a lack of expertise and bandwidth amongst trustees. Comments by trustees made within the CMA roundtable discussions are consistent with this view of constraints on expertise and bandwidth. For example, "Attendees noted that lay and member nominated trustees generally have a limited amount of time to devote to their trustee duties".[20]

4.3 However, in WTW's view, the CMA has misdiagnosed the root cause of certain market dynamics. Although the evidence presented in the various Working Papers is consistent with WTW's assessment that limited expertise and bandwidth are at the heart of the challenges faced by scheme trustees, in a number of instances the Working Papers fail to recognise the centrality of the lack of bandwidth and expertise facing trustees. At the very least, the CMA has not fully articulated that this issue is the central feature that may give rise to an AEC.

4.4 For example, in the Working Paper on Information on Fees and Quality, the CMA reviewed the materials and information provided to trustees as part of the reporting activities of providers and concluded that trustees receive limited information on certain aspects of service. However, the trustee survey found generally that trustees had very positive views of the information they receive and their ability to monitor their provider. In our view, providers are responding to client demands for information to be provided at the right level of detail to allow them to obtain an accurate picture of the performance and costs of the scheme – without being overburdened with too much detail given the constraints they face in terms of time and resources. While there may be scope for some improvements – for example, around standardising information across providers, which the industry is currently taking active steps towards – the observed levels of information are limited because of the demand side constraints, and not because providers are limiting information in order to distort client choices.

4.5 WTW therefore believes that the CMA would arrive at a much deeper understanding of market developments, the issues faced by trustees, and the solutions to these issues that the market has developed, if it were to acknowledge the centrality of the constraints on bandwidth and expertise faced by trustees.

We encourage the CMA to give further consideration to the value that FM delivers for pension schemes

4.6 One of the key solutions developed by the market to the constraints on bandwidth and expertise faced by pension fund trustees is the introduction of the FM service. As the CMA will be aware, the FM service delegates responsibility for portfolio management and execution to the FM provider, freeing up trustees to focus on higher level strategic issues.

[20] Paragraph 3 of the Note of CMA roundtable discussions with pension trustees (1 & 2 May 2018)

4.7 To date, the CMA has not properly assessed the additional value provided by the FM service to trustees, the extent of benefits to trustees and sponsoring employees if the FM service were taken up more widely in the market, or the extent to which conflicts and barriers are preventing wider take-up of this service. WTW considers the CMA has taken a narrow view on how to measure the value added by the industry (by focusing on asset manager recommendations) and has not identified the most relevant barriers to the industry achieving better outcomes. WTW submits that the CMA should fully address this issue.

4.8 In this regard, WTW has provided evidence to the CMA of the value of that its FM service has created for pension fund trustees to date. In particular, this evidence shows that the funding levels of WTW full FM clients experienced significantly less volatility and stronger growth than the average UK DB scheme, since the inception of the service (although we expect similar results to apply across the industry). These results are statistically significant and robust, and they go to the heart of the value added by the investment consulting industry, namely helping their clients achieve better risk-adjusted returns for their assets.[21]

4.9 The summary of the roundtable discussions points to the value of improved performance:

> "Some trustees noted that a small improvement in fund performance… could easily equate to a whole year's IC fees." [22]

4.10 Other parties have also communicated that the FM service is suitable to alleviate the governance burden of pension scheme trustees. For example:

(a) In its write-up of its round-table discussions with asset managers, the CMA noted that "Broadly, asset managers viewed fiduciary management as a suitable governance solution for some pension schemes, as they believe that some pension scheme trustees generally lack sufficient investment expertise to take complex financial decisions."[23]

(b) The PSLA has similarly noted that "Fiduciary management (FM) as an approach can offer many benefits to schemes, including the ability to take investment implementation decisions nimbly in response to market developments and a reduced governance burden more generally. There are also benefits to this service being offered by a scheme's incumbent investment consultant (IC) as they may have a good understanding of the history and objectives of their clients."[24]

4.11 As a result, WTW considers, in line with wider views, that there would be considerable gains to pension fund trustees from a greater level of take-up of the FM service. Moreover, WTW believes it is possible to quantify at a broad level the benefits that would arise. In particular, since risk management is central to the value that investment consultants provide to pension fund trustees, and the FM service has provided much less volatile outcomes, it would be appropriate to measure the value resulting from this reduced volatility.[25]

4.12 One way to translate the benefit of risk reduction into a monetary estimate of the value that this could have created for pension schemes is by applying the Capital Asset Pricing Model (CAPM) framework. CAPM provides an approach for measuring the trade-off between risk and return for investible assets. We have applied this framework to quantify the extent to which pension scheme's sponsoring

[21] This approach provides a much better assessment of the overall value added by the investment consultants than analysing asset manager recommendations alone, which has been the focus of the CMA's and FCA's analysis thus far. WTW notes that it does not consider the CMA's analysis of WTW's asset manager recommendations to be robust. Had the CMA applied the same range of statistical tests to WTW's data that it applied to the wider industry, the conclusion would have been that WTW's buy-rated products do in fact outperform on a statistical significant basis, and on a gross and net basis, for the majority of the tests considered.
[22] Paragraph 14 of the Note of CMA roundtable discussions with pension trustees (1 & 2 May 2018).
[23] Paragraph 11 of the roundtable discussions with asset managers (12 February 2018).
[24] PLSA response to the Working Paper on the supply of fiduciary management services.
[25] The CMA has not captured the benefits of reduced risk in any of the analysis in the working papers.

employers – and ultimately their investors – would place on the reduction in undiversifiable risk exposure exhibited by the less volatile pattern of funding level progression experienced by WTW's FM clients to date, compared to the highly volatile pattern of funding level progression exhibited by the average UK DB pension scheme over the same time period. As set out in further detail in Annex 2, we estimate that the higher risk observed for the average UK DB scheme, compared to the historical performance of WTW full FM clients, equates to an implicit risk premium of [✂]% per annum using the CAPM approach.

4.13 The total size of the UK DB pension scheme industry is approximately £1.6tn, of which approximately £1.2tn are in schemes that are using IC rather than FM. We recognise that not all schemes using IC services would perform as poorly as the average UK DB scheme; some schemes are well resourced and achieve excellent performance using advisory services. However, even if only 10% of IC schemes would have achieved such benefits from a switch to FM, this would still amount to risk reduction benefits equivalent to £[✂] per year. This is a huge potential benefit to the industry that – had it been realised – would likely have dwarfed any potential benefits associated with other remedies that the CMA currently appears to be considering on the basis of the issues it has set out in working papers. In addition, we note that WTW's full FM clients have achieved higher average returns since the inception of WTW's FM service. Applied to the same 10% of IC clients, this further increase the benefits that FM would have delivered in recent years to £[✂] per year.

4.14 Further detail on the CAPM framework and these calculations is provided in Annex 2.

We also encourage the CMA to consider any barriers that may be limiting the take-up of FM

4.15 The level of potential benefit identified above is extremely substantial, and so it would appear to be in many pension fund trustees' interests to switch to FM. However, as we have previously submitted, take-up of FM has been relatively slow in the UK compared to other countries such as the Netherlands. It is therefore an interesting question as to whether there are barriers to pension funds taking up the solution. Unfortunately the CMA has not considered the existence of barriers to take-up of FM in any of the working papers published or in the Issues Statement.[26] This seems to us a very significant omission in the CMA's investigation to date and should be addressed.

4.16 One potential barrier that has been raised by multiple parties, including trustees themselves, is that IC-only firms are incentivised not to raise FM to their clients, as if the client were to switch to FM the IC-only firm would lose money. For example:

(a) In the CMA roundtable discussions with pension trustees, the note states "Some trustees said that there was a risk that IC firms might deliberately avoid recommending FM if they did not offer the service."[27]

(b) JLT also stated the following in its response to the Working Paper on barriers to entry and expansion: "Equally this does not address the (hidden) conflicts of IC-only firms not recommending FM providers, even where such a move would be in the best interests of the trustees, sponsors and members."[28]

4.17 Given this, we submit it would be of great benefit to pension fund trustees if the CMA's focus could shift to supporting the industry in unlocking the potential of existing and future market-driven solutions – including FM – that could create huge value for UK pension schemes and their stakeholders, but where barriers may be limiting the extent to which that value is realised. This would address or mitigate the issues arising from the central concern we have identified. For instance, the CMA could investigate remedies to encourage trustees to review their governance arrangements and

[26] e.g Issues Statement paragraph 64 sets out the conflicts the CMA will consider.
[27] Paragraph 77 of the Note of CMA roundtable discussions with pension trustees (1 & 2 May 2018).
[28] JLT's *Response to Working Paper: Barriers to entry and expansion* dated 9 May 2018.

determine which IC or FM service model best fits their needs. This could be achieved by widening trustees' access to information on the numerous characteristics of FM which include better risk and volatility management. In addition, WTW would encourage the CMA to explore forms of aggregation or consolidation of pension trusts to benefit from economies of scale (of which FM is one example), as proposed in its Statement of Issues.[29]

4.18 As noted above, the track record of FM services to date suggest that there is significant potential benefit to be unlocked by addressing any such barriers that may be preventing or impeding the uptake of such services. Such are the benefits of FM that even if these barriers had only prevented a small proportion of pension schemes from taking up the service, they would still constitute a significant AEC.

5. Some of the possible remedies put forward by the CMA in its Issues Statement and Working Papers could benefit pension schemes, but others would be disproportionate or even harmful

5.1 WTW is committed to ensuring the best outcomes for trustees and their pension schemes. As discussed above, our view is that the CMA should focus on measures that will directly tackle the most pressing challenges faced by customers in the industry. To that end, WTW supports remedies which would improve trustee empowerment and choice, in particular those remedies focused on resolving the underlying organisational issues affecting trustees (i.e. the lack of bandwidth and expertise) and would strongly encourage the CMA to consider such remedies. We are concerned that the CMA has, as yet, provided little or no indication that it is considering such measures. We do recognise that some of the remedies that the CMA has proposed could generate some benefits for pension schemes. However, other potential remedies that the CMA has put forward would not only fail to resolve any AEC, but also cause significant detriment to pension schemes by impeding initiatives designed to tackle the key challenges facing the industry.

5.2 The remainder of this section summarises which remedies we think could bring some benefit to schemes, and which remedies we think would be clearly harmful for pension schemes. Annex 1 provides full details of WTW's position on each remedy proposed by the CMA in each of the published Working Papers.

Some remedies proposed by the CMA may be of some benefit to pension schemes

5.3 We consider that the following potential remedies put forward by the CMA could be beneficial for pension schemes if they are developed and implemented in the right way.

- ***Improving information transparency***

5.4 We are generally supportive of measures to improve the transparency of information on fees and quality, and have supported initiatives by the industry to date. Initiatives that make it easier for trustees to process information on fees and quality could alleviate any resource or time constraints, and make it easier to assess and compare the offering of different providers.

5.5 The measures should *not*, however, introduce unnecessary additional burden and complexity for trustees that may already be struggling with the information they currently have. In addition, any measures should be designed carefully to ensure unintended consequences do not arise, such as excessively focusing trustees' attention on aspects of investment consultants' service that are easier to understand or compare (for example, service cost compared to service quality). Any attempt to standardise the presentation as well as the content of such information would also need to be carefully considered. While standardisation can improve comparability, imposing a "one size fits all" approach could limit providers' ability to design services that meet client requirements, and to innovate.

[29] Paragraph 111 of the Statement of Issues.

5.6 With all this in mind, we are open to the CMA introducing measures to set sensible standards for the information that investment consultants provide where these have varied between providers in the past. For example, standards vary across the industry in the following areas of reporting:

(a) **Monitoring service quality.** WTW supports the CMA's proposals to improve the standardisation of information on FM performance provided to prospective clients. The industry has been working on a framework for measuring performance comparably across providers[30]. WTW would welcome the CMA's support in making this performance standard practice for the FM industry. For example, we would support a remedy that required all FM providers to submit the information from the Performance Measurement Standard as part of any tender.

(b) **Reporting to clients on third party fees.** WTW acknowledges that more could be done to provide additional information on third party fees, especially the total expense ratio (TER) of underlying manager fees and expenses, as well as any changes to fees as a result of portfolio changes. There has been significant progress in this area already following the significant requirements under MiFID II.

(c) **Providing comparable information on FM fees for prospective clients.** WTW recognises that clients looking to appoint a fiduciary manager may struggle to compare the offers of different providers. WTW therefore supports measures to improve the comparability of fees for FM services. Requiring fiduciary managers to provide information on fees on an unbundled basis and report the total expense ratio would be one helpful measure to improve prospective clients' ability to understand and compare the cost associated with the fiduciary management service. We note that a similar solution will not work effectively in the case of IC services as the cost of the service will be driven to a large extent by client requirements which are only fully scoped out during the initial meetings following an appointment, and evolve during the course of the appointment. Again, significant requirements through MiFID II means that progress has already been made in this area.

(d) **Sharing information on client feedback.** WTW supports the collection and dissemination of client feedback to enable trustees to compare levels of service quality and client satisfaction. WTW acknowledges that, even though measures to improve transparency around client satisfaction and service levels are welcome, the data collection process will involve a cost implication, regardless of whether the information is collated by the firm or a third party.

- ***Requiring clearer processes for IC providers' role in the transition from IC to FM***

5.7 WTW's view is that there is no conflict of interest for IC-FM providers from providing both services, and that the CMA has not identified any evidence that this leads to distorted outcomes. Nonetheless, we note that some trustees surveyed had the perception that such a conflict may exist and we would support measures that would help dispel such misperceptions.

5.8 For example, while WTW has rigorous standards to avoid any conflict and does not provide any services advising trustees on the suitability of FM or the selection of an FM provider, this may not be the case for all providers. Therefore, we are supportive of clearer guidelines for IC-FM providers to adequately deal with such situations. The following measures may be appropriate in this regard:

(a) Providers should not be allowed to act as intermediaries in selection processes where they are tendering for services themselves.

(b) IC providers should not be allowed to act as third party evaluators for their own clients to support them in assessing the suitability of FM as an alternative to IC. In our view, this is

[30] The initiative was initially coordinated by IC Select and it is our understanding that it will now be taken forward by the CFA.

particularly problematic for IC-only providers that would have an incentive to steer clients away from FM solutions.

(c) IC mandates should specify in their terms that the advisory service does not extend to advising clients on the suitability of alternative governance models such as FM services.

- ***Requiring market testing on first adoption of FM services***

5.9 We recognise that switching from IC to FM is an important decision for trustees and that choice of FM provider could have material implications for pension scheme outcomes. We would therefore support measures to encourage trustees to engage in market testing when they first appoint a full FM provider.

5.10 While formal tendering may be the right solution for some schemes, it would not be appropriate for all schemes given the cost and time involved in running a formal tender and the variability in the size of schemes and mandates (in particular in the case of partial FM). We therefore do not think the blanket imposition of mandatory formal tendering would be proportionate. We would be happy to work with the CMA to explore suitable remedies that are proportionate for smaller and less material mandates.

Other remedies proposed by the CMA would be highly detrimental for pension schemes

5.11 We consider the following remedies proposed by the CMA to address its theory of harm regarding incentives for IC-FM providers to steer clients towards their in-house FM products are not only unnecessary – given the absence of evidence that IC-FM providers distort their clients' decisions in this way – but would also cause significant harm to pension schemes.

(a) **Structural separation of IC-FM firms**. Such a remedy would destroy value for pension schemes, given the clear economies of scope associated with offering both IC and FM services and the potential value to clients of staying with a provider whose investment approach suits them well when migrating from IC to FM. For many clients, there are significant benefits from obtaining both their IC and FM services from a single provider. Forcing legal separation of companies may also result in slower take up of FM for clients that would benefit from FM solutions, if trustees considered that they faced a choice between the best solution for the scheme (migrating to FM) and the best provider for the scheme (their current IC provider). Finally, the remedy would be directly anti-competitive by artificially reducing the range of providers available to trustees, would introduce additional potential conflicts of interest and would discourage innovation in developing new products.

(b) **Internal separation and controls, e.g. Chinese walls**. While this would allow companies to continue to benefit from some economies of scope (for example, from having a joint research function), it is clear that in order to separate the functions internally there would necessarily be considerable duplication. The skill set required for both services is very similar and the FM provider would have to gather information on the client which the IC division would already have, and there would have to be separate reporting on and separate meetings for each service potentially increasing costs for clients. The two aspects of service are very integrated and so dealing with these in a disjointed manner could be very detrimental to both client service and client outcomes.

(c) **Prohibiting cross-selling of advisory and FM services**. We consider that this would limit choice for our clients and reduce value for those clients who would benefit from receiving integrated services. It would also clearly reduce competition if the incumbent IC provider were prohibited from providing FM services to that scheme. Potentially the incumbent IC provider is a particularly good match for that client, so that including them in the tender would generate more competitive pressure. In contrast, prohibiting the incumbent provider from tendering for the service would reduce the competitive pressure in the tender and could result in worse outcomes for schemes.

(d) **Mandatory switching**. The CMA has produced no evidence that the act of switching provider in and of itself leads to any benefit to clients or that current levels of switching are sub-optimally low. In fact, the analysis produced as part of the gains from engagement Working Paper found that there was no statistically significant difference in fees between schemes that switched away from their IC provider when first adopting FM services and schemes that did not switch and were not engaged (according to the indicators that the CMA used to measure engagement). Forcing clients to switch would be anti-competitive as it limits the competitor set that can tender to provide FM services. It may also deter some trustees from switching to FM if they are satisfied with their provider and would have to discontinue the relationship upon adopting FM. On top of all this, it would disincentivise firms from providing a high quality of service to their existing client base, since investment consultants would perversely be punished by focusing their resources on serving their existing customers as opposed to competing for new business. Trustees were not in favour of mandatory switching, as noted in the CMA roundtable discussion summary[31]. The PLSA also noted that it would be harmful for pension schemes, increasing cost and reducing choice[32].

5.12 Our view is that the CMA should rule out all remedies identified above given the lack of evidence that an AEC exists in relation to the joint provision of IC and FM services, and the clear negative impact these remedies would have on client choice and competition in the IC and FM markets.

WILLIS TOWERS WATSON

8 JUNE 2018

[31] Paragraph 90 of the Note of CMA roundtable discussions with pension trustees (1 & 2 May 2018)
[32] PLSA response to the Working paper on the supply of fiduciary management services

Annex 1

1.1 Although we have addressed the proposed remedies in detail in our responses to the Working Papers, we bring together below our comments in relation to the key remedies proposed in the suite of Working Papers.

Information on Fees and Quality

1.2 The Working Paper proposes a number of remedies including:

(a) Mandating comprehensive disclosure of fees and charges with minimum frequency, including in relation to third party fees for current clients.

WTW recognises the benefits of ensuring that trustees are given an appropriate level of information on fees and strives to provide clients with detailed information on total fees on a regular basis in relation to both advisory services and FM. WTW believes that the standards for cost disclosure – in particular for the investment arrangements embedded in FM mandates – will ensure transparency of the fiduciary manager's fees and that of the agents they employ on their clients' behalf.

However, it is less clear that the need for this remedy has been identified by the Survey since trustees already appear satisfied with the level of information provided to them based on the results of the Survey, as set out on slides 20 and 21 of the Fees and Quality Working Paper.

Having said that, WTW acknowledges that more could be done to provide additional information on third party fees, especially the total expense ratio of underlying manager fees and expenses, as well as any changes to fees as a result of portfolio changes.

MiFID II, which recently came into force, will enhance pricing transparency in relation to fee reporting for FM and advisory clients. In addition, the Institutional Disclosure Working Group is expected to make its final recommendations on the disclosure of costs and charges by July 2018 with the aim of ensuring consistent and standardised disclosure of costs and charges to institutional investors. Therefore, MiFID II and the Institutional Disclosure Working Group's recommendations should largely address any shortfalls in information on fees.

(b) Guidance to current client trustees on requesting and interpreting fee information, potentially including templates.

WTW broadly supports this remedy and is of the view that it would be easy to implement. However, there is a question mark over how helpful the use of off-the-shelf templates would be due to bandwidth and expertise constraints. Indeed, the reference to "trustee' engagement and confidence" made by the CMA[33] appears to recognise such issues. Additional guidance could even place further burdens on those trustees who are already stretched and unable to process high volumes of information. Such trustees may also be unable to identify what is most helpful to them in terms of fee information.

(c) Introducing a standard baseline level of scheme performance information including frequency, requirement for net/gross returns and focus on member outcomes for current clients.

WTW supports standardising the information on scheme performance provided to current clients. WTW would like to reiterate that an approach to performance measurement should not simply focus on returns. In WTW's experience, some trustees place an excessive focus on monitoring short term manager performance, perhaps because it is relatively straightforward

[33] Pages 36 and 55 of the CMA's Fees and Quality Working Paper.

to do so, even if it is not the most important feature affecting fund performance. Instead, effective performance measurement should be a holistic analysis that covers as many of these sources of added value as possible, including both risk- and return-related benefits.

A drawback of mandating a standard baseline level of scheme performance information is that it would increase costs for trustees.

(d) Guidance to trustees on requesting performance information and how to interpret it could help trustees ensure they ask for and receive the appropriate information, but is dependent on trustee engagement and confidence for current clients.

WTW recognises the benefits of providing guidance on requesting and interpreting performance information and in theory supports the potential remedy. Having said that, there is already a lot of guidance materials available to trustees and there is little evidence that there is demand for additional materials or that such guidance will address the underlying issues.

(e) Introducing a duty for firms to provide a minimum level of fee information would standardise the information provided and ensure that trustees receive it for prospective clients.

WTW considers that there is merit in standardising the information on fees provided by parties during the process of appointing a new fiduciary manager . However, WTW's view is that the nature of the investment advisory service, which is a much more bespoke service that is typically not well specified at the point of making the appointment, means that attempting to standardise information on fees or mandate the form that these should take during the tender process will be much more challenging.

(f) Adoption of a standardised approach to FM performance and use of composites for prospective clients.

WTW fully supports the CMA's proposals to improve the standardisation of information on FM performance provided to prospective clients. The industry has been working on a framework for measuring performance comparably across providers ("the Performance Measurement Standard").

WTW agrees that the efforts to standardise FM performance reporting are an overwhelmingly positive development, and that in the long run this should improve competition and market outcomes in the sector.

Having said that, although WTW is supportive of standardising the methodology of FM performance reporting at points of procurement, a balance must be struck in terms of how this information is disseminated. There are potential unintended consequences of performance track records of FMs becoming publicly available. Publicly available track records of FM performance could have an impact on the behaviours of both FM providers and trustees such as herding, similar to those behaviours witnessed in the 1990s when league tables of balanced managers were regularly published.

(g) Introducing a standard baseline level of scheme performance information for advisory firms to standardise the information provided for prospective clients.

The industry has also been exploring the potential for a Performance Measurement Standard for advisory services. While WTW recognises that a standardised measure of performance would be helpful for clients looking to appoint a provider, this is more problematic for advisory services.

The main limitation is that, in the case of the advisory service, the performance of the scheme is the result of the quality of advice given by the investment consultant and the quality of the decisions made by the trustees. These two elements cannot be disentangled in the observed outcomes. An additional complication is that not all advisory clients have a clearly specified objective for the mandate, which means it is not possible to segment the client population into composites and control for risk appetite.

In addition, even if the trustees take on all the advice received, the speed at which they are able to implement it varies considerably between schemes and this can cause large differences in scheme performance.

(h) Introducing a tender toolkit would potentially reduce the burden on trustees and improve the quality of the information requested.

WTW considers that while there is no obvious harm from introducing new materials and toolkits to help trustees assess performance as part of the tender process, there are already a lot of guidance materials available to them and it is unclear that there is demand for additional materials. Therefore, it is not obvious that producing such a toolkit would have a material impact on trustees' ability and confidence to assess performance of providers.

(i) A remedy that requires the collection of objective client feedback and dissemination to prospective clients.

WTW supports the collection and dissemination of client feedback to enable trustees to compare levels of service quality and client satisfaction. Although there are no public measures of service quality currently available, WTW is committed to ensuring client satisfaction and uses the following inputs to assess quality standards:

(i) the Independent ClientFirst™ programme, a client satisfaction programme whereby clients are asked to provide feedback on WTW's services – including price – via an in-person interview. These clients will often have a perspective on WTW's pricing relative to competitors which is an input to our pricing decisions. Notes from these meetings are shared with the team delivering services and with senior management;

(ii) feedback from tenders and re-tenders;

(iii) data which WTW has prepared summarising the performance of its FM clients relative to the average UK pension fund (please note that this is not a comparison with other fiduciary providers as this data is not public); and

(iv) assurance reports on internal controls prepared by WTW's Reporting Accountants.

WTW acknowledges that, even though measures to improve transparency around client satisfaction and service levels are welcome, the data collection process will involve a cost implication, regardless of whether the information is collated by the firm or a third party.

1.3 WTW considers that the CMA's proposed remedies would have more impact if they were more explicitly focused on resolving the underlying behavioural issues affecting trustees, i.e. lack of bandwidth and expertise. The evidence in the Working Paper does not support that this is obviously due to either a lack of information, or a lack of standardised information.

1.4 In addition, WTW would like to reiterate that the Working Paper on Fees and Quality does not explain why it is proposing the specific remedies identified when i) prima facie, the results of the survey of pension scheme trustees carried out by the CMA seem to suggest that the vast majority of trustees are happy with the information received and ii) the CMA has not suggested that trustees are asking for the wrong type of information, or too little information, for their needs.

Asset manager product recommendations

1.5 Although the CMA found that firms present information on the potential or actual impact of their asset manager product recommendations in different formats and using different terminology, it did not propose any remedies but welcomed views from the parties on a number of questions to assist it in designing potential remedies.

1.6 WTW strongly believes in the value of its asset manager product recommendations and would welcome well-designed initiatives to improve the ease with which clients can assess and compare the performance of different investment consultants in this regard. Having said that, asset manager product recommendations are only one aspect of investment consultants' performance. The CMA will be aware that we have previously submitted that there is already a risk that pension fund trustees focus excessively on manager selection at the expense of other aspects of performance (e.g. overall strategy, asset allocation, liability hedging). The CMA's approach in this Working Paper could exacerbate this concern by raising the profile of manager selection decisions to the detriment of other (often more important) aspects of performance, if care is not taken to ensure that pension fund trustees continue to assess performance in the round.

Supply of fiduciary management services by investment consultancy firms

1.7 Remedies include:

(a) Mandatory tendering on first adoption of FM Services / mandatory tendering within a fixed period after first appointment / periodic mandatory tendering

(b) Trustee reporting to scheme members or TPR

(c) The provision of guidance to trustees on the adoption and selection of an FM provider

(d) Mandatory switching

(e) Structural remedies (legal separation of Investment Advisory and FM, prohibition of cross-selling advisory and FM services)

1.8 WTW does not object to mandatory tendering if the CMA considers that a feature giving rise to an adverse effect on competition exists and can see that such a remedy would require each trustee to consider the position of the incumbent advisor. However, it is not clear to WTW on the basis of the Working Paper that such an adverse effect on competition has been identified. The CMA should consider the consequences of this remedy for smaller schemes (e.g. those with AUM of <£100m) where the costs of a competitive tender may be disproportionate compared to the benefits it would offer.

1.9 WTW notes that there will be costs associated with the tendering process and switching IC and/or FM providers. The choice of IC and/or FM providers is often a part of a long-term strategy of a pension scheme. WTW further notes that this is also a reason why some trustees do not switch on a frequent basis, as opposed to any inherent incumbency bias or trustee apathy. In WTW's experience, trustees are highly engaged in any discussion and decision-making regarding a switch from advisory to FM services. Such a switch is a major strategic decision, and is likely to be considered very carefully by trustees.

1.10 WTW does not believe there can be any justification for a structural remedy splitting up the investment advisory and fiduciary management businesses. In fact, such a remedy would itself be detrimental and have adverse effects on competition. None of the evidence suggests a concern that would warrant a structural remedy. Crucially, outcomes for customers and market outcomes have not been discussed and these are important analyses which should be included for a holistic assessment. Indeed, the survey results are evidence that a significant number of the trustees that consider an issue to exist already consider it well managed. A remedy designed to build on the conflict of interest policies and procedures that already exist would be proportionate.

1.11 We believe that client outcomes would be adversely impacted were this value chain to be broken by a structural remedy, whether by not allowing a single firm to possess both strategic consulting skills and implementation services, or by not allowing a single firm to provide the full range of services to a client.

Trustee Engagement

1.12 Remedies centre around the following three aims:

(a) Measures to better inform trustees of switching costs

(b) Measures to empower and incentivise trustees to engage

(c) Measures to reduce FM switching costs (CMA noted the potentially high switching costs in FM)

1.13 MiFID II will more or less render the proposed remedy under 1.12(a) unnecessary.

1.14 WTW broadly welcomes appropriate measures to improve governance standards as well as the requirement that trustees should provide additional guidance on how they assess and obtain value for money.

1.15 As mentioned above, WTW would in theory support the introduction of mandatory tendering at the point of moving to a fiduciary manager service. However, mandatory tendering would be excessively onerous on smaller schemes as it would introduce disproportionate costs. In WTW's experience, the average tender process requires approximately [✂] to complete and will require each bidding firm to invest on average [✂], as well as a very considerable workload for trustees. This therefore risks aggravating rather than ameliorating bandwidth concerns.

1.16 With regard to mandatory switching, as mentioned at the hearing with the CMA on 21 November 2017, it is very likely that potentially adverse consequences would arise from introducing mandatory switching. Forcing trustees to switch provider even if they are satisfied with their advisor's performance – and the CMA Survey shows that 95% of trustees are very or fairly satisfied – would seem to be a perverse outcome of this process, and be vastly disproportionate.

1.17 The CMA conceded at paragraph 131 of the Working Paper that it has not at this stage taken a view on whether switching costs are high or whether they are more or less controllable. Moreover, the fact that a scheme will incur switching costs from moving to an FM arrangement from an IC arrangement should not detract from the fact that FM is a better service for many pension schemes which in the long run will provide a number of additional benefits.

1.18 It is in every FM provider's best interest to ensure that any transaction costs are minimised and recouped through future investment returns and/or risk reduction. The costs will be included in the performance of the total scheme which the FM provider is accountable for. However, there may be a number of unintended consequences of limiting the level of change to an underlying portfolio if there are any restrictions. Changes to portfolios take into account the benefits and costs and in WTW's experience, any change in a client portfolio when switching to an FM model is analysed appropriately, taking into account the benefits and costs of the change.

1.19 WTW maintains that the evidence relied upon by the CMA in the Working Paper suggests that the trustees are generally engaged and that the IC-FM market is competitive. Nonetheless, WTW welcomes appropriate remedies to enhance trustee engagement by addressing the underlying problems where trustees have a lack of resources. We suggest that the CMA further consider remedies in respect of three issues:

(d) improving trustee board composition;

(e) aggregation and consolidation; and

(f) assisting trustees in tender processes.

Competitive Landscape

1.20 This Working Paper did not set out any potential remedies.

Barriers to Entry and Expansion

1.21 This Working Paper did not set out any potential remedies.

Financial Performance and Profitability

1.22 This Working Paper did not set out any potential remedies.

Gains from Engagement

1.23 This Working Paper did not set out any potential remedies.

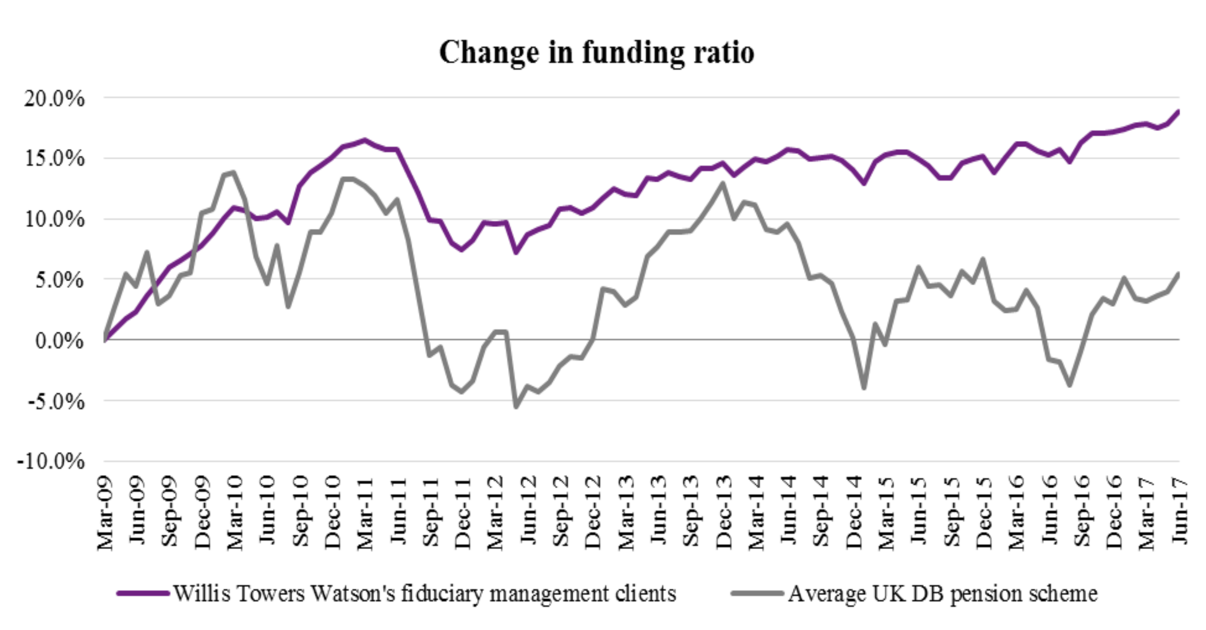
Annex 2

1.1 This annex provides further information on our calculations to quantify and illustrate the potential value that FM clients stand to gain from reducing the volatility in their funding ratio, drawing on the experience of WTW's own FM clients to date. We first briefly recap the evidence that we have previously submitted to the CMA on the relative performance of WTW's FM clients. We then consider how the value of this outperformance could be quantified. Finally, we consider what our results would imply about the potential benefits of remedies designed to encourage other pension schemes to consider migrating to from an IC to an FM service where appropriate.

Recap of evidence previously submitted to the CMA on the relative performance of WTW's FM clients

1.2 In our standalone submission on performance measurement issues in January 2018[34], we shared a chart with the CMA that compared the funding performance of WTW's FM clients against that of the average UK DB pension scheme. For convenience, this chart is reproduced in Figure 1 below.

Figure 1 – Performance of WTW's fiduciary management clients against benchmark, 2009-17



Source: WTW.

1.3 The metric used in this chart is the funding ratio – the level of funding of the client as a proportion of the full funding rate – adjusted to strip out the impact of any contributions by sponsors. As we explained in our January submission, this metric appropriately captures performance in both the asset and the liability dimensions, and therefore provides a good measure of the overarching performance of different DB schemes.

1.4 The chart demonstrates strong performance for WTW's FM clients in two respects.

(a) First, it shows that the funding ratio of WTW's FM clients has improved to a greater degree than the average scheme.

(b) Second there is much less volatility in the funding ratio over time for WTW's FM clients. As explained in our January submission, WTW considers that this reflects its efforts to better

[34] WTW *Submission on Performance Measurement Issues*, 16 January 2018.

identify the sources of potential risk and to put in place actions (such as hedging and diversification) to reduce and mitigate these risks. In the occasions where such risks materialise, WTW's clients' funding ratios should therefore be less affected. This benefit matters to pension trusts' sponsoring employers (and, ultimately, their owners and shareholders), who are less exposed to the risk that they may be called on to step up their contributions as a result of unexpected deterioration in the scheme's funding ratio.

1.5 In our January submission, we took this graphical analysis a step further and formally tested the differences in both the (i) volatility of the funding ratios and (ii) the average increase in the funding ratio between the average UK pension scheme and the average WTW FM client. We found that:

(a) the funding ratio performance of WTW's FM clients (as measured by monthly changes) are statistically significantly less volatile than the average UK pension scheme; and that

(b) the monthly change in funding ratio is statistically significantly greater than zero for WTW's fiduciary management clients, but is not statistically greater than zero for the average UK pension scheme.

1.6 We also found these results to be robust to changes in the starting date assumed for the analysis (i.e. re-running the analysis from a starting point later than March 2009).

Quantifying the value of this outperformance

1.7 The statistical tests that we conducted for the purposes of our January submission paper demonstrated that the outperformance by WTW's FM clients was statistically significantly greater than zero, but they did not seek to quantify the value that this outperformance creates for pension schemes and their sponsoring employers.

1.8 In order to quantify the value of this outperformance to date, one needs to find a way of evaluating how much value pension trusts and their sponsoring employers place on not only improved funding ratio, but also the reduction in risk associated with the scheme. As noted above, both aspects of performance matter because they reduce the risk that sponsoring employers will be called upon to provide additional funds to ensure that the scheme can meet its liabilities.

1.9 In this regard, the performance of the scheme can be likened to the performance of an asset in which sponsoring employers and their shareholders have invested. One can evaluate the cost of investing in such an asset using the Capital Asset Pricing Model (CAPM), which describes the return that investors demand for investing in assets of various levels of (undiversifiable) riskiness.

1.10 For illustrative purposes, we have therefore used the CAPM framework to estimate how much more compensation an investor would have demanded for investing in an asset with the highly volatile return profile akin to the funding profile of the average UK DB pension scheme, compared to an asset with the less volatile profile akin to that exhibited by WTW's FM clients to date.

1.11 Below we first provide a brief overview of the CAPM framework and then explain how we have used this to quantify the value of outperformance by WTW's FM clients.

The CAPM framework

1.12 The CAPM framework works from the principle that an investor will trade off risk and return when considering investment decisions. Specifically, it states that investors will demand a Minimum Expected Return (MER) when investing in a specific asset or mix of assets with a particular risk profile. They should invest in an asset if they expect its return to be greater than this MER value.

1.13 The MER of an asset or group of assets is calculated as follows:

1.14 $r_a = r_f + \beta_a (r_m - r_f)$

Where:

r_f = risk free rate

β_a = the beta of the asset

r_m = the expected market return

1.15 $(r_m - r_f)$ is commonly known as the market, or equity, risk premium, or the additional return that investors require to hold assets with the risk profile of a market equity product.

1.16 The CAPM model enables us to consider the MER of assets that are riskier than a risk-free asset, but less risky than a market equity product. The CAPM model achieves this through the beta parameter, which reflects the sensitivity of the asset's return to a unit change in the market's return (the logic being that the risk of investing in an asset that is not closely correlated with the market return can be diversified, whereas the risk of investing in an asset that is closely correlated cannot). The lower the beta, the lower the asset's level of undiversifiable risk.

1.17 The beta parameter for an asset i can be calculated as follows:

$$\beta_i = \frac{Cov(r_i, r_m)}{Var(r_m)} = \rho_{i,m} \frac{\sigma_i}{\sigma_m}$$

1.18 This equation shows that the beta of an asset can be decomposed as the underlying correlation in the asset's returns with the market's returns $(\rho_{i,m})$, multiplied by the ratio of the standard deviation of the asset's returns (σ_i) to the standard deviation of the market's returns (σ_m). This means that, all else the same, if an asset's return is highly correlated with the market, or if the standard deviation in an asset's return is high relative to that of the market, then the beta parameter will be larger.

1.19 Using the beta parameter in combination with the risk free rate and the equity risk premium, the CAPM therefore determines the MER of any given asset based on its undiversifiable risk level. This shows that the difference in beta values for different assets will determine the difference in MER for those assets. In this way, by using the CAPM framework and estimating the beta parameter for two different assets, we can quantify the benefit of investing in an asset with lower (undiversifiable) risk in terms of the reduced MER requirement.

Applying CAPM to compare the performance of WTW's FM clients and the average UK scheme

1.20 To compare the performance of WTW's FM clients against that of the average UK DB pension scheme using the CAPM framework, we have first converted the funding ratios reported in Figure 1 above into a "returns" metric.[35] In our view it is reasonable to convert the funding levels to returns in this way since – while in reality pension schemes are not assets in which one can invest – they are nonetheless represent a stream of liabilities (i.e. potential contribution payments to top up the funding level of the pension scheme) to which sponsoring employers and their investors are exposed. All else being equal, sponsoring employers and their investors will prefer a scheme to have:

(a) a higher funding level; and

(b) a lower level of (undiversifiable) risk exposure that results from volatility in that funding level.

1.21 Using these "returns" metrics, we have used the CAPM framework to calculate the MER that investors would demand in order to invest in an asset with a returns profile akin to that which we have

[35] To do this, we calculated an absolute value of the deficit/surplus in funding for a pension scheme of a given size, based on the observed funding level. We then calculated what these monthly funding deficit/surplus values implied the level of assets in each pension scheme was, assuming that liabilities were constant. Then we used the percentage change in the monthly implied assets values to generate our "returns" measure.

calculated for WTW's FM clients and then compared this to the MER required for an asset with a returns profile akin to that which we have calculated for the average UK DB pension scheme.

1.22 To do this we have assumed:

(a) A risk-free rate (r_f) of 3%[36] – though the results of our calculation are in fact invariant to the assumed level r_f.

(b) An equity risk premium ($r_m - r_f$) of 5.7% based on a study by Norges Bank published in 2016, a study by KPMG published in 2017, and two online sources[37].

1.23 To estimate the betas, we have regressed the "returns" profiles of first the average UK DB pension scheme and then WTW's FM clients on the returns profile of the FTSE All Share index, which provides a proxy for the market return. The resulting coefficients provide the following beta estimates:

(a) 0.44 for the funding level of average UK DB pension scheme;

(b) [✂] for the funding level of WTW's FM clients.

1.24 This difference in these beta estimates mainly stems from the average UK DB pension scheme exhibiting a higher level of volatility than that of WTW's FM clients (as is clearly apparent from Figure 1 above).

1.25 Using the CAPM formula, the MER estimates for the average UK DB pension scheme and the WTW's FM clients respectively are therefore as follows:

(a) 3% + 0.44 * 5.7% = 5.5%

(b) 3% + [✂] * 5.7% = [✂]%

1.26 The difference between these estimates – [✂]**%** – is the additional return that an investor would demand for investing in an asset with a highly volatile return profile akin to the funding level of average UK DB pension scheme compared to an asset with a less volatile return profile akin to the funding level of WTW's FM clients.

Implications for the potential value of encouraging other DB pension schemes to switch to FM

1.27 The foregoing analysis suggests that the lower volatility in funding ratios experienced by WTW's FM clients would be of significant value to sponsoring employers and their investors. Furthermore, this has been achieved without sacrificing improvement in funding ratios: on the contrary, as Figure 1 above shows, the outturn funding ratios of WTW's FM clients have also improved relative to those of the average UK DB scheme.

1.28 One can use these results to think about the potential benefit – in terms of reduced volatility in funding ratios – that other DB pension schemes might have realised if they had taken up an FM service:

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[36] Data from http://www.market-risk-premia.com/gb.html shows that the risk-free rate has fluctuated between 1% and 5% from 2000-18. In any case, we note that the assumption on the value of the risk-free does not affect our estimate of the value of reduced risk, given that we assume an equity risk premium ($r_m - r_f$) of 5.7%.

[37] There are a range of potential estimates for the equity risk premium, but generally these are between 5% and 6% today.

- A recent Norges Bank study found that the geometric average of the equity risk premium for the UK, calculated using data from 1946-2014, to be 5.7% (https://www.nbim.no/contentassets/2b92009ffa9440f98eec8f32a0996ca2/discussion-note-1-16---equity-risk-premium.pdf).
- A recent report by KPMG recommended the use of an equity risk premium of 5.75%, based on analysis for several developed markets (https://assets.kpmg.com/content/dam/kpmg/nl/pdf/2017/advisory/mrp-summary-july-2017.pdf).
- Another online source (http://www.market-risk-premia.com/gb.html) finds an implied UK equity risk premium of 5.89% for December 2017.

(a) We estimate on a conservative basis that the total AUM of UK pension schemes that currently use advisory-only IC services (rather than FM) is approximately £1.15tn.[38]

(b) If we suppose that just 10% of these schemes by AUM had in fact been in FM schemes since 2009 (i.e. £115bn of AUM) and that – as a result – those schemes would have exhibited the return and risk characteristics of WTW's FM clients rather than the UK average pension scheme, then the value of the reduced risk these schemes would have faced would have been [✂]% * £115bn = £[✂] per year.

1.29 We should emphasise that we consider this to be a conservative estimate, since it assumes that only 10% of UK DB schemes that currently use advisory only services would have benefitted in this way from migrating to FM. For the reasons we have explained in our previous submissions, we believe that in reality the FM model can deliver benefits to a wide range of schemes.

1.30 Furthermore, as noted above, the £[✂] annual benefit estimate focuses solely on the reduction in risk exposure associated with migrating to a FM model. In addition to this, the outturn funding ratio of WTW's FM clients increased by [✂]% (or about [✂]% per annum on average) relative to that of the average UK DB pension scheme between 2009 and 2017. Factoring this improvement in the outturn funding ratio in on top of the reduced volatility would more than double our £[✂] benefit estimate above to approximately £[✂].

1.31 Clearly there is potentially room for debate about the exact values of some of the parameters that we have used in the calculations set out above. But whatever the exact values, the foregoing analysis indicates that the overall benefit to pension fund trustees from the FM service has been significant, as reasonable changes in these parameters will still give rise to overall benefits of a similar order of magnitude.

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38 This is a rough estimate, based on the following:

- At the end of March 2018, the total AUM of UK DB pension schemes was £1.58tn. (Source: http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx)
- In Paragraph 72 of the Competitive Landscape working paper, the CMA state that "73% of schemes purchase IC services." We assume that the percentage of AUM with IC-only schemes is also equal to 73%. This is likely to be conservative, on the basis that it is smaller clients on average that do not use IC.