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Dear Peter

Investment consultants market investigation

KPMG Response to CMA Working Paper 8

Please find enclosed the response submitted on behalf of KPMG LLP to the CMA's Working Paper dated 10 May 2018 on Gains from Engagement.

Yours sincerely

KPMG LLP

Enclosures: *KPMG response to Working Paper*

KPMG LLP

24 May 2018

KPMG response to Working Paper

Thank you for affording us the opportunity to comment on the CMA's working paper "Gains from Engagement" (the "**Working Paper**"), published on 10 May 2018, which analyses the extent to which lack of engagement may lead to adverse customer outcomes.

In our response to the Working Paper, we will focus on the investment consultancy ("**IC**") model rather than the fiduciary management ("**FM**") model, given that KPMG does not provide FM services. Some of our broader comments may nevertheless apply to the FM models and findings.

Our comments on the Working Paper are noted below.

Overview of Working Papers and key comments

1 The CMA's analyses aim to identify the relationship between engagement[1] and prices, through both descriptive statistics and an econometric approach. We focus our response on the latter analysis. We would expect an econometric analysis to allow for the identification of the effect of the CMA's engagement variable on prices, while holding other relevant variables constant.

2 The CMA has carried out an analysis that aims to explain the hourly price of IC services as a function of the CMA's engagement indicator, AUM, hours spent by consultants, and number of services purchased. The CMA has also carried out sensitivities, which include additional variables in the analysis, and considered additional indicators of engagement.

3 The CMA has concluded that engaged schemes pay less for IC services than disengaged schemes[2], whilst acknowledging some limitations, such as the lack of significance in the model which includes firm fixed effects, or the fact that it cannot control for non-price outcomes.

4 We consider that the CMA has drawn incorrect interpretations and in turn conclusions from the results of the IC analyses, and that its results suffer from a number of potential shortcomings that have not been appropriately considered:

a. the CMA's own models show that there is no statistical difference between the prices paid by engaged and disengaged customers for IC services once firm fixed effects are controlled for. By not using these models as the baseline specifications to form its conclusion, the CMA:

- is inconsistent with its methodology elsewhere in the Working Paper;
- neglects a potentially important driver of price variation; and
- places secondary importance on those specifications that provide the highest degree of explanatory power,

[1] In this analysis, the CMA has constructed a binary indicator of whether the customer is considered engaged or not, based on whether the customer has carried out any one of the following: tendered its business; employed a third-party evaluator (TPE), or having a Professional Trustee (PT). The CMA has also considered these three definitions of engagement in isolation. We provide considerations on the appropriateness of these measure in paragraphs 17 to 19 of this response.

[2] Working Paper, paragraph 7

b. the methodology implemented when creating the dependent variable, which captures the hourly price of IC services, has not been consulted on by the CMA. As a result, the model does not account for important variation that will have been created by the CMA by creating an hourly price. The underlying mix of staff on an engagement has a significant bearing on the hourly price observed – engagements with more senior staff time, for example, will have a higher hourly price;

c. the construction of the engagement variable relies on a narrow set of indicators being able to capture the level of engagement of customers. For example, the CMA considers that customers are engaged if they employ a Professional Trustee, (but the CMA's own previous analysis has shown that the vast majority of trustees hold a relevant professional degree); and

d. there are a number of gaps in the CMA's commentary that limit our assessment in the absence of any further disclosure. For example, the CMA's choice of baseline model has not been justified nor has it provided any commentary on its views regarding the fit of the model. Additionally, the CMA has not indicated whether it has tested the appropriateness of the variables included, whether any outliers are present and how sensitive results may be to removal of those outliers, and the functional form of the analysis. We therefore cannot provide any more detailed views than those already outlined.

5 Overall, while we appreciate that the CMA recognises that its results are less robust for IC than its other findings,[3] we do not consider that the CMA can place any weight on its conclusion that there is some evidence "that engaged schemes pay less than disengaged schemes"[4] based on the analyses it has undertaken in IC and the points made above.

The CMA's model shows no statistical difference between engaged and disengaged customers in IC

6 The CMA presents, in Figure 10 on the main body and Table 14 of the technical appendix to the Working Paper, a series of results for baseline and core sensitivities for the econometric model of engagement in the IC segment. These purport to identify a statistically significant effect of engagement on IC prices. In Table 15 instead, results are presented for models which include additional sensitivities such as provider fixed effects. These models do not identify a significant effect of engagement on prices. The CMA places weight on the former results, concluding that there is evidence of the effect of engagement on prices, whilst acknowledging that the latter results make its position less robust and ultimately concluding that the CMA is unable to place more than indicative weight on its findings for IC.[5]

7 In our view, the specifications which include provider-specific fixed effects are likely to be more robust. As we outline in paragraphs 8 – 10 below, it is not clear as a matter of economic logic nor econometric standards how a different conclusion could be drawn.

[3] Working Paper, paragraph 7.
[4] Working Paper, paragraph 7.
[5] Working Paper, paragraph 193.

8 Economic logic suggests that provider-specific fixed effects are likely to be relevant in this model. It is reasonable to assume that there will be some price difference across providers, considering this is a differentiated market. If there are also differences in the share of "engaged" customers across providers, but provider fixed effects are not controlled for, the model may incorrectly infer a relationship between the price and engagement variables which is actually due to provider differences. I.e., there is variation in the model caused by underlying mix effects in the data that is not being controlled for.

9 This is borne out by the fact that the large majority of the models which include provider fixed effects have greater explanatory power than the specifications that do not include them, as indicated by their adjusted R-Squared values.[6]

10 The CMA itself considers these effects relevant, and includes them in the baseline specifications of other models along with explanation as to why they are important to control for (e.g. in the FM models, as detailed in paragraph 91 and 172(f)). It is therefore inconsistent for the CMA to not include these effects within the baseline specification of its IC analysis.

The construction of the dependent variable creates a mix effect that is not adequately controlled for

11 In its IC analysis, the CMA uses the hourly price of IC services for a given engagement as its dependent variable (constructed as total spend divided by number of hours).[7]

12 As noted above, we were not consulted on the methodology being undertaken by the CMA in this analysis. We think it is highly likely the CMA is missing an important control variable that will help to explain some of the variation in hourly price observed. We would note that the needs of our clients are heterogeneous and no single engagement is the same. As a result, our engagements require staff with different skill sets and a different mix of senior and junior staff. In order to understand the average hourly price observed for an engagement, it is important to consider this expertise mix, which in itself is determined by client heterogeneity.

13 As an example, some clients require a light touch monitoring service and our involvement is largely limited to meeting attendance, whereby the average hourly rate will be high, even if the absolute level of fees is quite low. In contrast, we have developed a proposition for smaller clients where the majority of the work is undertaken by more junior colleagues. The average hourly rate would be lower in this case.

[6] The adjusted R-Squared is higher in all but one specification. That particular case, the specification labelled "Add Yr mandate gain", includes fixed effects for the year in which the provider took on the mandate for the client. Only one of these fixed effects is significant, and indicates a very strong negative effect on prices: contracts signed in 2014 are 20% cheaper than contracts signed in 2011. Despite this very large and significant coefficient, the CMA has not provided commentary on this result. We would assume that this could be the result of some outliers in the year 2014, but without access to the analysis and with no reference in the Working Paper on the treatment of outliers, we are unable to comment further on this potential issue.

[7] As mentioned above, the CMA mentioned it has estimated, though not reported, models that include total spend as a dependent variable.

14 This is illustrated in part by the CMA's own descriptive statistics, such as figure 19, which indicate a wide spread of differing hourly rates, for both engaged and disengaged schemes.

15 We do not consider that the explanatory variables included in the analysis would appropriately control for this, and it is therefore a (potentially significant) limitation of the CMA's model. The CMA's sensitivities that use total spend will suffer from a similar issue.

16 We would additionally note that the CMA acknowledges that it has not considered quality as an outcome. It states that its analyses understate harm as a result. It is not clear to us how this conclusion has been derived, not least given that any observed price differentials may be explained by unobserved quality differentials (i.e. mitigating the harm).

There is mis-measurement in the definition of the engagement variable

17 Engagement is defined across three categories: whether a customer tendered its IC business; whether the customer employed a third party evaluator (TPE); and whether the customer employed a Professional Trustee (PT). A customer is considered engaged if it has done any one of these activities.[8]

18 We can appreciate the CMA can only use quantifiable factors when constructing this variable, and agree with the limitations it outlined.[9] Our view, however, is that this variable is likely to be mis-measured, potentially significantly. In our experience, we have many clients who would not meet the CMA's quantifiable criteria, but show high levels of engagement both in terms of negotiating fees and service levels.

19 This is supported by other work conducted by the CMA, For example, research quoted by the CMA indicates that seventy percent of non-professional trustees have a "relevant" qualification, defined as a professional qualification relating to finance, investments, pensions, law or actuarial sciences, which we would consider to be highly relevant in terms of engagement – it is not clear why the CMA would consider that these qualified trustees are less likely to be engaged than Professional Trustees.[10]

The CMA has omitted important commentary from its Working Paper

20 There are a number of gaps in the CMA's commentary that limit our assessment in the absence of further disclosure.

21 For example, the CMA's choice of baseline model has not been justified nor has the CMA provided any commentary on its views regarding the fit of the model. We note that, for example, the adjusted R-Squared statistic in the CMA's baseline model is 0.45 – suggesting a substantial amount of variation is left unexplained. This seriously restricts the ability of respondents to analyse the CMA's approach and submit adequate representations. To assess any pattern in the unexplained variation, we

[8] The CMA also assessed the three effects in isolation, finding that results hold for the Tender and PT definitions, but not for the TPE. The CMA comments that this may be due to only a small fraction of the data being recorded as having a TPE.
[9] Working Paper, paragraph 174.
[10] CMA Working Paper on Trustee Engagement, paragraph 41.

would require information on the residuals and other regression output which has not been provided.

22 The CMA has additionally not indicated whether it has tested the appropriateness of the variables included, whether any outliers are present and how sensitive results may be to removal of those outliers (e.g. through a cooks distance test), and the functional form of the analysis. We therefore cannot provide any more detailed views than those already outlined.

23 Given the importance of these factors to the CMA's conclusions, we would welcome the opportunity to engage further with the CMA on these points.