Willis Towers Watson

INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT SERVICES MARKET INVESTIGATION

RESPONSE TO WORKING PAPER ON GAINS FROM ENGAGEMENT

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24 MAY 2018

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

WTW RESPONSE TO WORKING PAPER ON GAINS FROM ENGAGEMENT[1]

Overview

1.1 WTW welcomes the opportunity to respond to the working paper on the gains from engagement paper published by the CMA on 10 May 2018 (the "**Working Paper**"). We understand that the overall objective of the Working Paper was to determine whether more engaged customers in the market received better outcomes.

1.2 We agree with the CMA that having an engaged trustee customer base is an important prerequisite for a well-functioning market that produces good outcomes for schemes, including – but not limited to – competitive IC and FM fee rates. We would therefore expect the evidence to be generally supportive of the view that more engaged customers are able to achieve better outcomes for their schemes.

1.3 However, the analysis presented in this Working Paper does not demonstrate a link between engagement and improved outcomes in any robust manner. We summarise our main concerns regarding the analysis presented in the Working Paper below, and provide more a more detailed explanation of each of these concerns in the attached Annex. Given the issues identified, we do not think that the paper can support any finding of detriment arising in the industry and the CMA certainly cannot place any weight on the finding, quoted in the executive summary of the Working Paper which states that customers who engage can expect to reduce their fees by as much as 25%. This is true in particular for WTW, given that the large majority of our clients are very engaged.

1.4 We note that the CMA has decided not to offer a confidentiality ring for the data and analysis until after the provisional decisions report and so our comments are based solely on the information presented in the Working Paper and the methodology explained within the Technical Appendix. Furthermore, the CMA has declined to answer a number of questions we submitted asking for clarity on elements of the methodology that were not clearly explained in the Working Paper. It is therefore not possible for us to comment on how alternative approaches would affect the results or on some detailed aspects of the CMA's methodology.

1.5 Despite our concerns that the analysis is not able to identify a clear relationship between the CMA's measures of engagement and prices paid by clients, we are not averse to sensible measures to encourage engagement as long as these are proportionate and affordable for less well-resourced schemes. One area where we believe there may be barriers to engagement, and which has been entirely omitted in the Working Paper, is around the gains from switching to FM. We believe that pension schemes for whom FM is appropriate would benefit materially from the removal of barriers to the uptake of FM, given the clear benefits of aggregation to many small and medium-sized schemes and the excellent track record of the service (which the CMA acknowledges in the Working Paper[2]). Given the clear conflict of interest applying to IC-only firms who would lose out if their clients switched to FM, there is the potential for harm to disengaged trustee customers that are, as a result, slow to consider whether FM is more appropriate for their needs.

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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 paragraph 52 of the Working Paper where the CMA alludes to "reasonably strong performance of the included firms' FM portfolios in recent years".

1.6 In what follows, we summarise each of our methodological concerns with the CMA's analysis. We have also provided an Annex explaining each of these concerns in greater detail.

The CMA uses an overly narrow definition of engagement

1.7 The CMA has used three indicators to determine whether clients are "engaged" or "disengaged". These are (1) whether the client has performed a formal tender, (2) whether the client uses a third-party evaluator ("**TPE**") and (3) whether the scheme has a professional trustee.

1.8 We consider that the analysis in the Working Paper has not accurately captured engagement in the following ways:

(a) Firstly, the CMA's analysis either ignores switching altogether, or includes it in the analysis in such a way that it remains outside the main assessment of the effects of engagement;

(b) Secondly, the indicator used for tendering only considers schemes that carried out a formal tender, while trustee boards that carried out more informal tenders (often for good reason) are treated as "disengaged";

(c) Thirdly, the choice of engagement indicators appears arbitrary given all the different ways in which trustee boards vary in their ability and approach to learning about the relative value of their service and that of alternative providers. For example, having a professional trustee is considered as an indicator of engagement, but having an investment subcommittee is not. The CMA has not set out the rationale for its choice of these indicators of engagement

(d) Finally, the Working Paper does not acknowledge that switching services from IC to FM is itself a signal of engagement, and does not seek to measure or take account of the gains from switching to FM.

1.9 In WTW's experience, there are clients that would not be identified as engaged under the CMA's three indicators but who are nonetheless highly engaged. For example, formal tenders can be expensive exercises for smaller, less well-resourced pension schemes and so these trustees are likely to take other more informal and affordable, but still effective, actions to test the market. WTW would also consider trustees who challenge and probe advice as highly engaged, yet this form of engagement is not captured by the indicators used by the CMA. While any of these indicators is, potentially, a sufficient condition for a trustee board to be engaged, they are certainly not necessary conditions. As a result, the CMA's measure of engagement is only a conservative proxy of actual engagement, and this reduces the reliability of the analysis.

1.10 WTW notes that the CMA has previously assessed trustee engagement in the Trustee Engagement Working Paper in terms of the following four factors (the "**Headline Factors**"):

(a) switching;

(b) tendering and/or switching;

(c) undertaking a formal review of fees and/or quality; and

(d) undertaking an external review of fees and/or quality.

1.11 However, it is unclear to what extent the CMA's previous assessment of engagement fits into the current analysis based on (1) whether the client has performed a formal tender, (2) whether the client uses a TPE and (3) whether the scheme has a professional trustee. WTW considers that there are a number of factors which are significant in evaluating trustee engagement. These factors encompass not only the indicators and the Headline Factors. Therefore, a thorough assessment of trustee engagement should adopt a holistic approach and take into account the totality of factors as opposed to a limited set.

The Working Paper is entirely focused on price as an outcome

1.12 The Working Paper indicates that "(t)he market outcomes experienced by pension schemes may vary in several different ways", including returns on the scheme's assets, discounts from asset managers that the provider is able to secure, or quality of service on softer factors such as the clarity of communication with the client. We would add one additional, and crucial, element of the value IC-FM providers bring to clients: risk management. Ultimately, what clients care about is overall value for money and, more specifically in the case of the trustees of DB schemes, the success of the IC-FM firm in ensuring that the scheme can meet its liabilities.

1.13 While we do not deny that the fees paid to providers are a relevant dimension on which competition takes place, our view is that the exclusive focus on price is unnecessary. In the annex to this paper, we have proposed ways in which the CMA could measure the overall value of the FM service, building on evidence shared in previous submissions.

1.14 Any proposed remedies should be informed by the evidence, and in failing to consider the evidence on how engagement affects the wider outcomes for schemes, the CMA may miss an opportunity to remedy features of the market that are causing real harm to pension schemes (for example, and as mentioned above, the potential harm from disengaged trustee customers being slow to take up FM where it can deliver higher and more stable growth in funding ratios).

The CMA has not adequately taken account of the heterogeneity of services

1.15 The services offered by IC-FM providers are highly heterogeneous by nature: the offering varies by provider, and the needs of clients vary substantially. Some clients purchase limited advice, or FM on only a small portion of the scheme assets; in other cases, services are wide-ranging or apply to all scheme assets. This results in a large amount of price dispersion that in no way reflects different levels of customer engagement.

1.16 Given the large amount of dispersion in the outcome variable (price) there is a particular risk that, if other factors that influence price are not suitably controlled for, one may find spurious relationships in the data between price and those variables that are included in the model (for example, engagement). In other words, the measured effect of engagement on price is likely to be highly sensitive to the choice of controls used in the model and the functional form in the model specification.

1.17 The results presented in the Working Paper indicate that this is indeed an issue. Our view is that the Working Paper fails to deal with service heterogeneity in a sufficiently rigorous way. The CMA has not justified its choice of controls and model specification, and has not been consistent in its approach (using controls in some models that are not included in others, without any explanation for this).

Even setting aside these concerns, the Working Paper provides no reliable evidence on the relationship between trustee engagement and fee levels

1.18 From the tables shown throughout the Working Paper, it is clear that the results are highly sensitive to relatively small changes in specifications and even provide some counterintuitive results. For example:

(a) For the CMA's "transition-to-FM" analysis, the results become statistically insignificant when relevant controls are included and are materially reduced when observations for the three DC schemes in the sample are dropped from the analysis.[3]

(b) The CMA's analysis finds no clear evidence that schemes that switch provider (many of which ran formal tenders) achieve better prices than "disengaged" schemes that do not switch.[4] This is at odds with the CMA's conclusions about the value of client engagement and casts doubt on the reliability of the CMA's analysis.

1.19 Therefore, it is particularly important to test for robustness of the model results. Although the CMA has presented some sensitivities around its baseline model:

(a) It has not tested more fundamental variations of the model – such as treating switching provider or service as an indicator of engagement.

(b) Where it has obtained sensitivity results that did not confirm its theories of harm, the CMA has not interpreted this on a consistent and objective basis, i.e. setting the same standard for the tests as it has in other analyses.

1.20 In our view, the Working Paper does not provide a balanced interpretation of the results obtained and does not sufficiently caveat the conclusions in light of the sensitivity of results to the precise model used. Taken in the round, it is evident that no weight can be placed on the CMA's findings about the extent of the relationship between trustee engagement and fee rates (and the CMA certainly cannot place any weight on the finding, quoted in the executive summary of the Working Paper, that customers who engage can expect to reduce their fees by as much as 25%).

1.21 The annex hereto sets out further information on these headline conclusions, along with a more detailed assessment of each of the tests presented in the Working Paper.

WILLIS TOWERS WATSON

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3 Table 4 of the Working Paper

4 Paragraph 74 of the Working Paper states that "Internally Acquired Schemes received lower prices than Externally Acquired Schemes"

2. ANNEX – METHODOLOGICAL CONCERNS WITH THE CMA'S ANALYSIS

2.1 In the Working Paper, the CMA has considered the impact of engagement on the fees charged by IC and FM providers. The CMA focuses on an engagement measure based on three criteria – (i) whether a formal tender has been carried out, (ii) whether a TPE was used and/or (iii) whether the trustee board has a professional trustee. The Working Paper then uses three approaches to compare fee outcomes for "engaged" and "disengaged" schemes:

- A static approach comparing the level of FM fees (per unit of AUM) in 2016;
- A transition approach comparing the ratio of post-transition FM spend to pre-transition IC spend when schemes transition to FM with the same provider;
- A static approach comparing the level of IC hourly fees in 2016.

2.2 We have four key concerns with the analysis in the Working Paper:

(a) It overlooks a number of important indicators of engagement, with the result that it defines many clients as being "disengaged" when it is clear that this is not the case;

(b) It is focused entirely on the price of the IC / FM service and does not consider wider, often more important, outcomes that determine the value of the service to schemes;

(c) It does not suitably account or control for the large amount of heterogeneity in IC and FM services, driven by client needs and providers' differentiated offering, which will influence the fees that different IC and FM providers charge different clients;

(d) Even setting aside these issues and taking the Working Paper's analysis at face value, the results provide no clear evidence of a relationship between engagement (as measured by the CMA) and fees. Furthermore, these results are highly sensitive to small changes in modelling assumptions, and the model specifications that underpin them look to be methodologically flawed.

2.3 Because of these concerns, we do not believe that the Working Paper's analysis provides a reliable insight into the impact of customer engagement on outcomes.

2.4 We discuss each of these points in turn below.

The Working Paper overlooks a number of important indicators of engagement

2.5 The stated aim of the Working Paper is to investigate the extent to which "difficulties in customers' ability to effectively assess, compare and switch investment consultants result in weak incentives for investment consultants to compete for customers".[5] Therefore the Working Paper should consider whether there is any evidence that trustee boards with higher levels of engagement, defined as an ability (and willingness) to "assess, compare and switch investment consultants", results in those customers obtaining better terms for their schemes.

2.6 We consider that the analysis in the Working Paper has not accurately captured engagement in two main ways. Firstly, the analysis has overlooked switching as a measure of engagement, even though suppliers who have actively chosen to switch their provider or IC or FM services have manifestly engaged in the market. Secondly, the measure of engagement is – even ignoring switching between providers – too narrowly defined since it does not take account of a number of ways in which some customers purposefully choose to engage. We consider two important forms of engagement that the

5 Paragraph 10 of the Working Paper.

Working Paper appears to have overlooked: informal tendering and investment subcommittees. Finally, we note that the act of moving from an IC to and FM service is itself an indication of engagement.

The Working Paper overlooks switching provider as an indicator of engagement

2.7 The CMA has made many references throughout the process (and in other processes) to the importance of the ability to switch as an indicator of the intensity of competition in the market. For example, in the Issues Statement, the CMA states:

> *"Difficulties in customers' ability to effectively assess, compare and switch investment consultants result in weak incentives for investment consultants to compete for customers"*[6]

and

> *"If customers (the demand side) are not able to effectively shop around, choose and switch products and suppliers, competition will be weak."*[7]

The CMA also recognises this in the Working Paper, noting that "all Externally Acquired clients have demonstrated some level of engagement in that they have changed provider when moving into FM".

2.8 As noted in the Trustee Engagement working paper, around 80% of trustees surveyed found it very easy to switch provider[8]. Although switching provider is not the only indicator of engagement, the CMA constructs an engagement measure that does not allow for it. This means that the CMA's classification labels some clients as "disengaged" even where they have actively chosen to switch provider (see, for example, Figure 2 of the Working Paper in which one of the CMA's client categories is "Externally acquired, but no engagement indicator").

2.9 The CMA's analysis therefore either ignores switching altogether or includes it in the analysis in such a way that it remains outside the main assessment of the effects of engagement:

- In the FM static approach, the CMA analyses the impact of the CMA's engagement indicators on the fees of schemes that stayed with their IC provider and does not analyse the impact of engagement for those who switched (we discuss this in more detail below).
- In the FM transition approach, the CMA only considers schemes that stayed with their IC provider.
- In the IC approach switching is entirely absent from the analysis.

The analysis overlooks informal tendering as an indicator of engagement

2.10 We do not have full visibility of how the CMA has constructed its engagement measures (while the CMA has said that it had to "manually map several responses into a more consistent categorisation" it has not provided more details on this mapping process). However, the Working Paper's description suggests that the CMA has only considered "formal" tendering exercises. Although we do not know how strict the CMA's categorisation was in labelling tenders as "formal", it would appear to overlook other ways in which trustees actively "shop around", including informal tenders and comparing quotes from a number of providers. This means that the CMA's approach might identify a

[6] Paragraph 43 of the Issues Statement.
[7] Paragraph 46 of Issues Statement.
[8] Table 3, Page 19 of the Trustee Engagement Working Paper; Table 4, Page 21 of the Trustee Engagement Working Paper

client as being "disengaged" in a situation where the trustee board had obtained information on a potentially large number of alternative providers, had possibly engaged in conversations with the different providers and had actively compared several offers.

2.11 Focusing solely on formal tenders in this way also overlooks the significant time and expense that such processes can involve, which may be disproportionate for smaller clients with limited resources (or clients that perceive they have less to gain from switching provider or service). For these clients, informally speaking to, and requesting quotes from, a number of IC or FM firms can offer a more cost-effective way of engaging in the market than a fully structured tender process.

The analysis overlooks having an investment subcommittee as an indicator of engagement

2.12 The other indicators of engagement that the CMA has used and ignored also appear to be arbitrary. For example, the CMA uses an indicator for whether the scheme has a professional trustee, but not one for whether the board has an investment subcommittee. Investment subcommittees are typically members of the trustee board that have specialist knowledge about investment and should be in a better position to make judgements about the value that the IC/FM provider is delivering. While we recognise that there is a need to keep the analysis tractable, it is not clear to us why a scheme with a professional trustee but not an investment subcommittee should be assumed to be "engaged" whereas a scheme with an investment subcommittee but not a professional trustee should be assumed to be "disengaged".

The analysis overlooks switching between IC and FM services as an indicator of engagement

2.13 The Working Paper fails to recognise that choosing to switch services from IC to FM is itself an indicator of engagement. In WTW's experience, trustees carefully consider their options before opting to move to an FM arrangement. As we have explained and evidenced in previous submissions, many schemes have benefitted significantly from making the transition from IC to FM. A well-functioning market is one that provides better outcomes for consumers and WTW has demonstrated that its FM service provides significant value for clients. Although certain measures considered by the CMA, for example around the ease of comparison and transparency are positive, the CMA should focus on the measures that will most effectively increase value for pension schemes, and therefore we are surprised that it has so far not considered the potential gains from FM and measures to encourage take up for those schemes that would benefit from it

2.14 In WTW's experience, the schemes that have switched to WTW to date are disproportionately large and well-informed. Many other smaller schemes that currently use an advisory-only service would also benefit from switching to an FM model – and in fact would be particularly well-suited to the service, given the benefits it can offer in terms of aggregation of bargaining power vis-à-vis asset managers and unlocking access to more sophisticated investment strategies than a small scheme could execute independently. The fact that take-up of FM service has not been more widespread among small and medium-sized schemes to date suggests that many such schemes are not as engaged in the market as they could be (typically because of the constraints they face in terms of resources and expertise).

In focusing exclusively on fees, the analysis ignores important – and measurable – wider outcomes of engagement

2.15 The Working Paper exclusively considers fees as an outcome of engagement. However, it is clear that it is not the only, or even the most, relevant outcome for schemes. Ultimately the clients of IC and FM firms care about receiving good value for money, and not simply a low price.

2.16 The CMA states that it has chosen to focus on fees because they are "measurable", but previous submissions by WTW have demonstrated how quality-related outcomes for schemes – such as funding level growth and reductions in volatility – can also be measured.

2.17 The additional benefits that FM services can offer over and above advisory-only services provide a clear example of this. As we set out in our submission on performance measurement issues, WTW's fiduciary management clients have systematically outperformed the average UK defined benefit pension scheme in risk-adjusted returns terms, achieving significantly lower volatility in funding ratios while at the same time achieving greater improvements in funding ratios.[9] These benefits can readily be quantified:

- In previous submissions to the CMA, we showed that WTW's FM clients have had better risk adjusted outcomes than the average UK DB scheme.[10] The schemes receiving WTW's full FM service experienced significantly lower volatility in their funding ratios, and higher annual average improvements in funding ratios in addition to this. It is clear that improved scheme risk-adjusted performance of this nature is a highly relevant outcome measure for the clients of IC-FM firms.
- To illustrate the importance of quality of service on overall outcomes, we can use an illustrative example based on the most recent round of triennial valuations – i.e. where schemes have re-struck their formal funding position from 31 March 2014 to 31 March 2017.
  - By way of context, as part of the triennial Actuarial Valuation that each Trustee Board is required to complete, the funding position is struck at the Valuation Date (this is a scheme-specific date, with 31 March or 6 April being the most common). This funding position reflects progress towards funding the scheme's liabilities and is therefore the key outcome that matters to scheme members and sponsoring employers – and, by extension, to the scheme trustees.
  - If we assume a £500m scheme that was 70% funded was following the average investment experience for UK pension schemes over this period, this would mean that it would now be 13% worse off in funding level terms, compared to the average experience of our fiduciary management clients. This equates to an additional funding shortfall of some £90m, to be met by the sponsoring company through additional contributions (assuming the trustees do not increase the level of investment risk to bridge the shortfall). In contrast the total fees that would have been paid to the FM provider over that three year period, would be in the region of £1m per annum, assuming a fee rate of 23.87 basis points (the mean value of FM fees reported in Table 5 of the Working Paper).[11]
- Although this is a simplified example, it illustrates the importance of pension schemes managing risk appropriately, and how the magnitude of the effects of such exposure can be considerably larger than that of the IC/FM fees paid.

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

[10] Please see Section 2 of our *Submission on Performance Measurement Issues*, and in particular the analysis set out in Figure 1, which suggested that the funding ratio of WTW's FM clients has improved by 15-20% between 2009 and 2017, in contrast with the funding ratio of the average UK DB pension scheme, which was only 5% higher in 2017 than it was in 2009.

[11] This is based on the following calculation: a scheme with liabilities worth £714m and an initial funding ratio of 70%, would have achieved a funding ratio of 75% under the WTW FM track record over that period, and a funding ratio of 62% if it had the same performance as the average UK DB scheme. This implies a difference in end-of-period assets between the two of £91m.

- An analysis that is limited to considering IC/FM fee levels as an outcome therefore misses a large part (indeed the majority) of the value of obtaining a “good deal” from one’s provider. We would urge the CMA to reflect this crucial element of the value of services in its analysis, since remedies designed to improve engagement which were too narrowly focused on price would miss a key part of how clients should assess and compare the offering of different providers, and could lead to a deterioration of services if, as a result, clients placed excessive focus on price.

The CMA has not adequately controlled for the highly heterogeneous nature of IC and FM services

2.18 As the CMA has recognised, the nature of services purchased by trustees may vary substantially both within and across investment consulting firms. This means that it is essential that any analysis of the relationship between customer engagement and IC/FM fees controls for such differences in service. In what follows, we first describe the different sources of heterogeneity in IC and FM services, and explain why this matters for the results of the analysis. We then set out our concerns about how the CMA’s approach has dealt with heterogeneity.

Scheme mandates are highly heterogeneous

2.19 The products offered by IC-FM providers are highly heterogeneous in a number of respects:

- Quality of the service varies between providers, with some providers being able to advise on and implement more sophisticated investment strategies and other providers offering a “lighter touch” service.
- In addition, clients’ needs vary widely. In some cases, this may be due to differences in clients’ investment beliefs (for example, preferences for more complex investment strategies) or the individual preferences of the trustee board (for example, the amount of client-facing time and / or information they demand from their IC-FM provider). However, client’s needs will vary depending on the point at which the scheme is in its life cycle, and the scheme’s funding level position.
- As a result of this, IC services vary substantially across schemes – ranging from project-based work or limited advice on particular aspects of investment (e.g. asset allocation) to advice on the full suite of investment decisions.
- Within FM, there is also significant variation in the service offered: partial mandates may be limited to narrow asset classes and/or a small portion of the scheme assets, whereas full FM services are responsible for the full spectrum of a scheme’s investments.

2.20 This heterogeneity is evidenced by the very large dispersion of the “price” distributions for the measures used in the CMA’s analysis, as illustrated by Table 1 below.

Table 1 – Distribution of price measures used in the Working Paper

Price measure	Mean value	Standard deviation	Minimum value	Maximum value
Implied basis points (total FM spend / AUM)	23.9	15.8	0.1	81.7
Increase in spend as a ratio of IC spend (after	5.1	5.0	0.7	24.8

transition to FM)				
Spend per hour for IC services (£)	294	111	34	704

Source: Tables 5, 7 and 9 of the Technical Appendix to the Working Paper, after exclusion of largest 5% of observations.

2.21 Given the high degree of service heterogeneity, it is important to control for the factors driving the variance in the outcome variable, as focusing on differences in fees without considering corresponding differences in service type and quality will paint a highly misleading picture of the potential gains from engagement and switching.

The CMA has not set out clearly how it deals with heterogeneity in scheme characteristics

2.22 The CMA recognises the importance of controlling for confounding factors in the analysis, noting that:

> *"There are many factors which might affect the prices of (and spend by) schemes, aside from engagement."*

and that

> *"Statistics which do not account for these other drivers could erroneously identify a relationship between engagement and price, or could erroneously imply such a relationship does not exist. In other words, we need to control for potentially confounding factors."* [12]

2.23 The analysis does include some controls for scheme characteristics but the Working Paper does not clearly explain its choice of controls. Given that model misspecification is likely to have a particularly large impact on the results because the heterogeneity is so extreme, our view is that the analysis required a much more detailed exploration of the suitable controls and functional forms for the model.

2.24 The Working Paper starts by presenting an analysis of "comparison of averages", initially without any controls and subsequently controlling for just two possible drivers of fees. The controls chosen vary depending on the analysis used:

- for the "static" approach, the CMA controls for scheme size and hedging; whereas
- for the "transition" approach, the CMA controls for whether the mandate is partial or full, and for hedging.

It is not clear why different controls have been chosen for different analyses in this regard, but in any event, it is clear that these are not the only drivers of service heterogeneity. Given, the importance of controlling for these factors, no weight can be placed on the "comparison of averages" results.

2.25 The Working Paper's regression analyses include certain controls either as linear effects or as dummy variables. However, the Working Paper provides no comment on the choice of these controls. Furthermore, there are several reasons why the functional forms used for these controls may not be suitable. For example:

- The Working Paper uses dummy variables for whether the scheme buys hedging and where schemes have performance related fees (where it controls for these factors at all). However, it

12 Paragraph 63 of the Working Paper.

seems plausible that a more detailed and larger amount of hedging or a higher level of performance related fees has a larger effect on the fees, and the CMA has not presented sensitivities to consider such an effect, or a rationale for why this is unlikely to affect the results.

2.26 Moreover, there are other controls that the CMA has not included in its analysis that are likely to be relevant. As noted above, there is considerable variation in the scope of the IC service for different clients, with some receiving very limited advice on certain aspects, such as asset allocation, and others obtaining advice on all different considerations, from the setting of objectives to research about specific asset managers of interest. Therefore, it would seem appropriate that any analysis that includes the fees for the IC service should control for the breadth of the IC service. However:

- The CMA does not control for this in any of the "baseline" analyses it has considered.
- In the FM "transition" analysis, the CMA provides one sensitivity where it restricts the sample to schemes that bought two or more IC services prior to switching to FM. It is not clear why the CMA introduced a binary variable (i.e. one service vs two-or-more services) in this regard, rather than simply including a variable for the number of IC services as a control.

2.27 Finally, the CMA's choice of control variables varies between the baseline regressions of the different approaches and the Working Paper provides no clear explanation for this. For example, several of the relevant controls for the "static" FM approach are dropped for the baseline of the "transition" FM approach or are not included in the IC analysis. This does not appear to us to be a reasonable approach – if certain factors have been found to be relevant drivers of fees under one approach, then there is no reason to exclude them elsewhere. The CMA appears to suggest that it chose to limit the number of controls for its transition approach because of the limited sample size it was working with[13], but excluding relevant control variables for this reason simply increases the risk of biasing the results, meaning that little or no weight can be placed on them.

2.28 One key set of variables that are included in some baseline regressions but not others in this regard are the firm fixed effects. Given the amount of differentiation between the offering of different providers, and the obvious relationship between quality and price, these are clearly relevant controls and the CMA should include them in all baseline models.

Even setting aside these concerns, the Working Paper provides no reliable evidence on the relationship between trustee engagement and fee levels

2.29 For the reasons set out above, the Working Paper has taken too narrow a view of both "trustee engagement" and "market outcomes" for the purposes of assessing the relationship between these factors. Furthermore, it has not adequately controlled for other factors that can significantly affect the one "market outcome" that the Working Paper focuses on, namely IC/FM fees. However, even setting these concerns to one side, the Working Paper still provides no reliable insight into the relationship between the CMA's chosen measures of engagement and the fees charged by IC/FM providers. We have a number of concerns in this regard, which can be summarised as follows:

- First, the "baseline" specifications produce counterintuitive results, which casts doubt on the weight that can be placed on them.
- Second, these concerns are further borne out by the fact that the CMA's results are highly sensitive to small changes in the chosen model specification, as well as the inclusion or exclusion of "outliers".

13 Footnote 64 of the Working Paper.

- Third, we have a number of detailed concerns about the methodological approaches underpinning the results that the CMA has presented for both its "static" and "transition" FM analyses.
- Fourth, rather than recognising the inherent fragility of its results, the CMA has framed its findings in an inconsistent way that appears to be geared towards supporting a conclusion that there is significant detriment in the industry.

2.30 We consider that these problems undermine the reliability of the CMA's results. We believe that where the CMA has reported statistically significant effects in its analysis, these are likely to be spurious.

2.31 We explain each of these concerns in turn below.

The CMA's "baseline" specifications produce counterintuitive results

2.32 Taken at face value, the results of the "static" analysis (summarised in Table 2 below) find no statistically significant evidence that schemes that do switch provider (many of which also ran formal tenders, etc) do better than schemes considered "disengaged" by the CMA that do not switch.

Table 2 – Headline results of the baseline "static" FM analysis, results are relative to the CMA's base group of "Disengaged, Internally Acquired" schemes

	Coefficient value (difference in implied price)	p-value
Engaged, Internally Acquired	-25%	2%**
Externally Acquired	-14%	12%

Source: Table 3 of the Working Paper

2.33 This is a surprising finding that is at odds with the CMA's conclusions about the value of client engagement, and casts doubt on the reliability of the CMA's analysis.

The CMA's results are highly sensitive to small changes in the chosen model specification and its statistical tests are likely to be low-powered

2.34 For the "transition-to-FM" analysis, which only considers schemes that stayed with their IC provider when first taking up FM, the statistical significance of the CMA's results is materially reduced when any of the following reasonable modifications are made to the analysis:

- When relevant controls that the CMA chose to include in its "static" baseline analysis are included in the "transition" regression, the engagement indicator coefficient for the transition regression becomes statistically insignificant at the 10% level;
- When the three DC schemes that were included in the baseline transition approach, but not in the baseline static approach, are removed from the sample, the engagement indicator coefficient for the transition regression becomes statistically insignificant at the 5% level;
- When the analysis attempts to control for heterogeneity in the IC service by excluding schemes that received less than two IC services prior to transitioning to FM, the engagement indicator coefficient for the transition regression becomes statistically insignificant at the 10% level;
- When the analysis is restricted to full FM schemes, the engagement indicator coefficient for the transition regression becomes statistically insignificant at the 10% level.

2.35 For the analysis of IC fees, the "baseline" model includes no firm-specific controls even though these are clearly highly relevant for the price of the IC service; once these are introduced in the baseline regression the p-value of the engagement indicator coefficient increases to 75%. In other words, the CMA's analysis has not found any clear evidence of a relationship between the CMA's chosen measures of engagement on the level of IC fees.

2.36 This is not to say there is no underlying relationship between customer engagement and fees (and indeed other market outcomes). However, the failure of the CMA's analysis to identify such a relationship is unsurprising, given that it has not properly measured engagement and has not adequately controlled for the significant degree of heterogeneity in the services provided to different clients in either the "baseline" regression specifications or the sensitivities it has considered. In combination with the wide variability in fees across schemes these and the relatively small sample sizes, these considerations mean that the CMA's analysis is likely to be low-powered.

2.37 In Paragraph 177, CMA itself recognises that "*the number of data points in several analyses is quite low"* and notes that this will also reduce the power of its statistical tests. However, in paragraph 178, CMA states that "*Given that we appear to have sufficiently high-quality variation to identify an effect, the first [problem that the CMA's statistical tests suffer from reduced power] does not appear to be a concern.*" We do not agree that any such inference can be drawn about the statistical power of the test on this basis. The fact that a regression model generates statistically significant results yields no reliable evidence about the statistical power of the model, since low-powered models are themselves entirely capable of generating spurious results that incorrectly reject the null hypothesis of no effect. On the contrary, there are clear reasons to believe that the CMA's analysis suffers from low statistical power for the reasons explained above.

Methodological problems in the CMA's "static" FM analysis

2.38 The CMA's baseline static FM model includes one dummy for clients that satisfy the CMA's indicators of engagement *and* are internally acquired and, separately, a dummy for externally acquired schemes. This means that:

- The model provides an estimate of the effect of being engaged (on the basis of the CMA's chosen indicators) on fees only for *internally* acquired clients.
- In addition, the model estimates the fee differential between internally acquired "disengaged" clients and all externally acquired clients (whether "engaged" by the CMA's definition or not).

The CMA appears to focus on the first of these coefficients as its headline result (according to the figures presented in the Working Paper, the first coefficient is statistically significant whereas the other coefficient is not).

2.39 We consider this to be an illogical model formulation given the CMA's stated theories of harm:

- If the CMA believes the effects of its measures of engagement on price may differ between externally acquired and internally acquired clients, then the right specification would be to include one dummy variable for each of the indicators of engagement and one dummy variable for externally acquired clients. This would allow one to identify the effect of engagement (according to the definition of the Working Paper), while controlling for whether the client had switched provider or not.
- If, alternatively, the CMA believes that switching provider is itself a signal of engagement, then it should treat switching symmetrically to its other indicators of engagement.

2.40 The CMA has not explained why it chose this unusual model specification. Furthermore, it has not explained why, in light of the counterintuitive results generated by this model specification (i.e. that schemes that have switched provider and may have engaged in other ways face no difference in fees compared to schemes that have not switched nor engaged in other ways), it believes it is not worth testing other model specifications.

2.41 Further, our view is that the way the measure of engagement is constructed – such that a single dummy flags any scheme that satisfies any of the three indicators of engagement – is unlikely to be the best way to control for engagement. The sensitivities presented in the Working Paper include three versions of the model that test individually for the effect of each of the CMA's engagement indicators, but the superior method to test for the individual effect of each indicator is to run the regression on all three variables to simultaneously obtain the coefficients of each. This allows one to observe the effect of, say, tendering while keeping constant whether the scheme has used a TPE or has a professional trustee. It is unclear why the CMA has not considered this standard approach, even as a sensitivity.

Methodological problems in the CMA's FM "transition" analysis

2.42 We have already commented on the sensitivity of the results of the CMA's FM "transition" analysis to the choice of controls above. In addition to this, we have concerns about the CMA's chosen outcome measure, which is "spend on FM services post-transition / spend on IC services pre-transition" for the following reasons:

- The CMA has based this analysis on the premise that "schemes with unobservably more complicated requirements are likely to spend more in both IC and FM, but there is less reason to believe that the ratio of their IC and FM spend should differ."[14] In other words, the CMA appears to be assuming that execution services scale with complexity in the same way as advisory services do – meaning that a client with more complex needs will consume proportionally more FM and IC services to the same extent.
- However, the CMA has provided no evidence to support this assumption. On the contrary, a client with a wide-ranging and complex IC mandate may not necessarily transition to a wide-ranging and complex FM mandate, or at least not to begin with: for example, a client could be buying advice on all its investment decisions and start purchasing partial FM services for a limited part of the scheme or a particular asset class; conversely the scheme could be buying limited advisory services and then move to full FM. As a result of all the possible permutations of the effect above, there may be significant variation in the FM-to-IC spend ratio that has nothing to do with different levels of FM client engagement. The CMA's analysis does not control for this.
- The CMA has also calculated the spend ratio on the basis of the average expenditure in the years before and after the transition to FM, rather than spend in the year before and after. The more standard approach to regression discontinuity analysis of this nature would focus on the jump in spend at the point at which the transition took place. The Working Paper does not explain why this approach based on average spend over a longer time period is preferable in the CMA's view.

The Working Paper does not frame the results of its analysis in a fully consistent and objective way

2.43 Where the results of its sensitivity tests do not support the theories of harm that motivate the Working Paper, the CMA does not appear to have interpreted these results on a wholly consistent and objective basis. For example:

14 Paragraph 70 of the Working Paper.

- Figure 6 of the Working Paper presents the results of the baseline static FM regression and reports the 75% confidence interval for each coefficient. On this 75% measure, the coefficient on "externally acquired" schemes would be statistically significant. However, the result is not significant at any of the standard levels of confidence (i.e. 99%, 95% or 90%) that the CMA has applied elsewhere in the Working Paper or indeed in other working papers such as that on asset manager product recommendations. The Working Paper does not explain why it considers a different threshold to be appropriate in this case.
- When discussing the same set of results in paragraph 89, the CMA states that that same coefficient on "externally acquired" schemes is significant at the 10% level (with the footnote indicating a p-value of 6%). However, this would appear to be factually incorrect on the basis of the information presented in Table 3 of the paper. This suggests that the correct p-value is 12%. On this basis, therefore, the model shows no statistically significant effect of switching on fees at the 10% level, compared to the fees paid by schemes that stay with their IC provider and are "disengaged".
- The Working Paper also states that the CMA places "more weight on the full FM results" for the transition analysis since the variation in scheme assets delegated is an important driver of fees and a "potentially confounding factor".[15] However, when considering the results of its econometric analysis elsewhere in the Working Paper, the CMA includes both partial and full FM mandates in its "baseline" analysis and does not comment on the fact its results become statistically insignificant when the analysis is restricted to full FM schemes.[16]

2.44 The CMA is also inconsistent in the weight it places on the results of its analysis. In paragraph 67 of the Working Paper the CMA notes that it is "not seeking to use its analysis to produce a precise estimate of the impact of engagement"; but that it is solely "aiming to test whether a relationship exists at a more general level". This is a sensible precaution in light of the difficulties associated with fully controlling for service heterogeneity explained above. However, this stated approach appears to be at odds with the CMA's choice to report a precise estimate of the impact of engagement in the Working Paper's executive summary, where it states that its econometric analysis indicates that amongst schemes who move into FM with their original IC provider, engaged schemes pay around 25% less than their disengaged counterparts".[17] Lastly, the CMA does not provide any explanations of the analysis it has produced which shows that there is no evidence that switching providers results in lower fees. For all these reasons, we are concerned that the CMA may have framed the results in an inconsistent way, rather than providing a balanced assessment that recognises the fragility of its analysis. An objective assessment of the Working Paper's results suggests that no weight can be placed on the CMA's findings about the extent of the relationship between trustee engagement and fee rates – including the finding that engaged schemes pay around 25% less than disengaged schemes.

15 Paragraph 104 of the Working Paper.

16 See in particular the results for Additional Sensitivity (1) for the FM transition analysis, presented in Table 13 of the Working Paper.

17 Paragraph 5 of the Working Paper.