RBB | Economics

Investment consultants market investigation

Aon response to updated market outcomes working paper

RBB Economics, 5 November 2018

1 Introduction and summary

1. This document, prepared at the request of Aon Hewitt Limited ("Aon"), responds to the CMA's working paper titled "*Working Paper: Market outcomes: updated results*", dated 25 October 2018 ("the WP"). The analysis which the CMA does undertake in this WP does not constitute persuasive evidence of adverse market outcomes in either the IC or the FM markets.

2. As Aon has previously submitted, the gains from engagement analysis presented in the PDR undermines the CMA's arguments in relation to IC to FM steering.[1] We note that in this WP, the CMA adduces no further evidence to seek to address this inconsistency.

3. The WP shows that schemes that stay with the same provider when entering FM are either better off (or at least not worse off) than if they switched to another provider.[2] Put simply, this strongly suggests that if IC-FM firms retain a high proportion of schemes that switch from IC to FM, it is not because such schemes are steered against their interest (and the CMA accepts this point[3]). It is because schemes are better off (or at least not worse off) from choosing this path.

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[1]   Aon's response to the PDR, paragraph 3.3.2, and Aon hearing with the CMA of September 27th 2018.
[2]   WP, column (4) of Table 2.
[3]   PDR, paragraph 42.

4. The WP demonstrates that based on the definition of 'engagement' adopted by the PDR there are no gains from engagement.[4] The WP therefore provides no evidence that low levels of engagement at the point of moving into FM, are a feature of the market that gives rise to an AEC.[5]

5. Perhaps in an attempt to side-step this issue, the WP has now implicitly redefined 'engagement' to mean tendering. The CMA then claims to have demonstrated gains from tendering. However, it has not done so. The results are not robust. The WP is selective in the control variables it includes and the analysis it presents. This is further discussed in **Section 2** below.

6. It is also puzzling that the CMA retains its 'transition' analysis. As set out in Aon's response to the gains from engagement WP and in its response to the PDR, the spend ratio used in the 'transition' analysis may in fact measure the opposite of what the CMA seeks to gauge.[6] The CMA again fails to acknowledge this criticism in the WP. This is also discussed in **Section 2** below.

7. Finally, as set out in **Section 3** below, we also note that inappropriate inferences are drawn from the CMA's analysis of the correlation between IC market shares and the Greenwich Associates ("GA") quality index of IC providers.

2 The CMA's updated gains from tendering analysis is presented selectively and is not robust

8. This section explains that the CMA's analysis of gains from *tendering* is not robust. As such, the WP fails to provide evidence of customer detriment.

9. The CMA presents a 'static' and a 'transition' analysis but it is unclear why the CMA retains its 'transition' analysis. As Aon previously indicated in response to the gains from engagement WP and in its response to the PDR, the spend ratio used in the 'transition' analysis may in fact measure the opposite of what the CMA seeks to gauge.[7] The CMA again fails to acknowledge this criticism in the WP.

10. Specifically, the CMA's 'transition' analysis purports to measure gains from engagement by comparing FM spend relative to IC spend (the 'spend ratio'). However, this approach is misconceived as the following hypothetical example demonstrates. Consider there are two similar schemes, A and B:

    a. Scheme A transitions from IC (where it paid £10,000) to FM (where is pays £50,000). Scheme A's spend ratio is 5.

    b. Scheme B also switches from IC, where it paid £9,500, to FM, where it pays £48,000. Its spend ratio is 5.1.

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4   WP, column (2) of Table 2, demonstrates that according to the approach adopted in the PDR there is no gain from engagement.

5   PDR, paragraph 64.

11. Scheme B is a more successful negotiator than Scheme A and secures better outcomes than Scheme A. However, the CMA's analysis would find it received a <u>worse</u> outcome. As such, the CMA's analysis is meaningless.

12. Nonetheless, even if one puts these significant concerns aside, the WP results are problematic when taken at face value.

13. By restricting its definition of engagement to tendering only, the WP finds the following:

    a. 'Static' analysis: IA schemes that have held a tender pay 20% lower fees than IA schemes that have not held a tender.[8] The CMA states that this finding is statistically significant.

    b. 'Transition' analysis: schemes that have held a tender face 34% lower fee increases than schemes that have not held a tender.[9] The CMA finds that this is statistically significant.

14. However, these findings are not robust. As a starting point, we highlight that the gains from tendering found in both the CMA's baseline 'static' and 'transition' models is statistically significant only to the 5% level of confidence.[10] This statistical significance frequently disappears (or drops to 10% at best) when sensitivity tests are conducted.

15. <u>First</u>, the table below shows that the baseline 'static' model presented in the WP lacks statistical significance when subjected to the following sensitivities:

    i. Restricted to IC-FM firms only (see Table 2, column (3) of the WP);

    ii. Excluding the percent of assets in FM (see Table 3, column (2));

    iii. Excluding the percent of assets in FM and dropping schemes with performance fees (see Table 3, column (3));

    iv. Controlling for the use of a structured bidding process (see Table 4, column (3)).

Table 1:   Engagement coefficients and statistical significance for WP sensitivities

	Table 2, column (3)	Table 3, column (2)	Table 3, column (3)	Table 4, column (3)
Coefficient on 'engagement' (IA and tendered)	-0.19*	-0.12	-0.26*	-0.22*
Standard error	0.105	0.094	0.134	0.113
p-value	0.069	0.191	0.052	0.050

*Source: The WP. Note: * denotes statistical significance to the 10% level of confidence.*

16. <u>Second</u>, the CMA has been selective in the control variables it includes in the specifications it presents. There are several examples of this in the WP:

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[8]   WP, column (4) of Table 2. When interpreting the coefficient of a non-logged independent variable in relation to a logged dependent variable, we apply the relevant exponential transformation.
[9]   WP, column (4) of Table 5.
[10]   WP, column (4) of Table 2 and column (4) of Table 5.

i. The results presented for the 'static' analysis in the PDR included only IC-FM firms. After correcting its underlying dataset and limiting the definition of engagement to tendering, the coefficient on IA engaged is significant only to the 10% level.[11] Without providing an explanation, the CMA then includes four non IC-FM firms in its analysis, resulting in a statistically significant finding to the 5% level.[12] This appears to be an arbitrary change to the sample to try to 'improve' the level of significance.

ii. When removing the percent of assets in FM from its baseline 'static' analysis, the 'baseline' finding becomes significantly insignificant (see "*Table 3, column (2)*" of the table above). That is, the removal of one statically insignificant variable from the CMA's 'baseline' model results in the finding that IA schemes that tendered paid fees that are not statistically significantly different from schemes that did not tender. Without providing a compelling explanation, the WP *excludes* schemes that use performance fees, resulting in statistical significance (see "*Table 3, column (3)*" in the table above). We note that by removing these schemes the WP limits the sample of schemes considered and potentially introduces a bias. Only schemes not using performance fees are included – this is therefore not representative of the market.

iii. When the CMA restricts its engagement measure to tendering only and runs its 'transition' analysis on its updated dataset, the coefficient on engagement becomes statistically insignificant.[13] Without providing an explanation, the WP *excludes* schemes that use performance fees. This adjustment means that schemes that tendered are found to incur fee increases that are 34% lower than schemes that did not tender. However, even after this arbitrary change, the result is only statistically significant to the 10% level of confidence.[14]

iv. The CMA then restricts the sample *further* to schemes that use fewer than two IC services, finding that schemes that tendered incur fee increases that are 34% lower than schemes that did not tender. This result is statistically significant at the 5% level.[15] We note that as a consequence of these restrictions the CMA has excluded one supplier entirely and reduced its sample of schemes by 40% relative to the PDR regression.[16] Once again the CMA appears to have made arbitrary changes to its sample to try to 'improve' the level of significance.

17. <u>Third</u>, the CMA does not present alternative specifications as sensitivity tests. If the adjustments to the sample highlighted in the preceding paragraphs were valid, then the CMA should apply them systematically and present the results as sensitivity tests. The CMA has not done so. We explored the implications of running these sensitivities in the data room. The results are presented in the confidential annex.

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[11] WP, column (3) of Table 2.
[12] WP, column (4) of Table 2. We note that the only effect of including these suppliers is to increase the number of EA schemes included in the model.
[13] WP, column (2) of Table 5.
[14] WP, column (3) of Table 5.
[15] WP, column (4) of Table 5.
[16] While column (2) of Table 5 includes four firms, columns (3) and (4) only include four. The number of schemes included in column (2) of Table 5 is 110 but this is reduced to 96 and 66 in columns (3) and (4), respectively.

3 The WP draws inappropriate inferences from the analysis of correlation between quality and market shares in IC

18. The WP responds to two criticisms Aon made of the CMA's analysis of the relationship between GA's quality index and market shares in IC. Namely, the CMA's analysis of market shares over time is misleading and its econometric analysis does not control for many other factors influencing market shares.[17] We address the WP's responses to these criticisms in turn.

3.1 Analysis of market shares over time

19. The WP itself demonstrates that the total market share of above average quality suppliers (as measured by the GA index) has increased since 2010. Specifically, Figure 1 of the WP shows that this value has increased substantially, from 11% to 29% in the past seven years. The total share of suppliers with below average quality have accordingly decreased during this time, from 78% to 60%.[18]

20. The WP notes that the decline of the below average quality supplier market shares is due to a single firm.[19] However, this critique is not relevant. First, the CMA's own evidence makes clear that firms with higher quality are able to gain share. Second, to the extent that some 'lower quality' firms failed to lose share, this may well reflect them offering their customers additional features that are not adequately captured by the GA index.

3.2 The CMA's econometric analysis is misconceived

21. As Aon set out in its response to the PDR, providers' market shares are a function of many factors (in addition to service quality). Many of these are omitted from the CMA's analysis, including returns, price and AM fee discounts.[20] The WP states that there is no evidence that the negative relationship between quality of service and market share is driven by price. By implication, the WP suggests that the variables omitted from its analysis are not expected to bias its results.

22. However, the explanation provided in the WP cannot be used to conclude that the negative correlation observed between market share and quality would persist if prices were controlled for in the CMA's analysis. While the direction of bias depends on the correlation of the omitted variable (price) with quality, it also depends on the relationship between price and the dependent variable (market shares) and on the relationship between price and all other independent (and omitted) variables. This would require the calculation of partial correlations, which the CMA has not carried out.[21]

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[17] *"CMA working paper on gains from trustee engagement – Response from Aon"*, paragraphs 3.14 to 3.17.
[18] The remainder of the market share (approximately 10%), is accounted for by firms with an unknown quality (see Figure 1 of the WP).
[19] WP, paragraph 25.
[20] *"CMA working paper on gains from trustee engagement – Response from Aon"*, paragraph 3.16. We note that the CMA's Summary of Trustee roundtable discussion held on 3 October 2018 noted this: "*cost was not the key factor for trustees as net of fees performance is more important*".
[21] See, for example, page 67 of Wooldridge, "*Econometric Analysis of Cross Section and Panel Data*", Second Edition.

23. We note that the WP only addresses the potential direction of bias introduced by the omission of prices from its analysis. A full consideration of the direction of bias introduced by the omission of other factors, and their respective correlations with prices, would be required to provide robust evidence on the relationship between market shares and quality.

24. In summary, without further analysis, the CMA is not able to predict the direction of the bias arising from these omitted variables. It therefore has no basis to presume that by leaving out important factors such as price that its analysis it will not overstate the negative relationship between quality and market shares.