

## INVESTMENT CONSULTANCY MARKET INVESTIGATION

### RESPONSE TO “MARKET OUTCOMES: UPDATED RESULTS” WORKING PAPER

This submission sets out the response of Mercer Limited (**Mercer**) to the CMA’s “Market outcomes: updated results” Working Paper (the **Updated WP**), published on 25 October 2018.

We welcome the CMA’s decision to revisit its economic analysis in the light of the comments that we, and others, have made.<sup>1</sup> Given the CMA is considering imposing remedies that will add costs to clients, it is important for the CMA to demonstrate that the benefit of these remedies clearly exceeds these costs, and that the remedies are effective, proportionate and reasonable to address client needs.

#### 1 Role of tendering in the market

- 1.1 As explained in our previous submissions, we support tendering as a method for clients to test the market.<sup>2</sup> Indeed, we believe that for the majority of clients the best way to appoint a fiduciary manager will be to run a tender process.
- 1.2 However, as explained below, the evidence does not show that running a formal tender is always the most appropriate approach, and thus that a mandatory tendering remedy is necessary or proportionate. We believe that it should be for trustees to decide what best suits their scheme in its particular situation. A best practice approach combined with a ‘comply or explain’ requirement meets client needs more effectively and is also consistent with the importance of this appointment alongside all the other appointments trustees need to maintain.

#### 2 How tendering affects fees – what the data shows

- 2.1 The CMA’s headline finding in the Updated WP, that “Internally Acquired” clients that do not run a formal tender pay 22% more than those that do, appears persuasive evidence on its face of the value of a tender process. If representative across the market, such an outcome might justify measures to require tendering for new fiduciary management (**FM**) appointments and for existing appointments to be revisited. However, in order to achieve this result, the dataset of FM appointments analysed by the CMA has been narrowed to the extent that the benchmark group is less than 3% of the market as it existed in 2016. Specifically, the benchmark group is comprised of fewer than 20 clients out of a total market of over 700.
- 2.2 This narrowing process is set out step-by-step in the **Annex** to this submission, although this is not made clear in the CMA’s analysis. As a result of the small benchmark group, the 22% figure is not based on data that is representative of the market and should not be used to justify a mandatory regime, particularly when a best practice approach would be more efficient and less costly.
- 2.3 In our view the key question is whether the evidence, taken as a whole, shows that trustees that run a formal tender achieve better prices than trustees that do not run a formal tender. Our advisers have used the CMA’s data and analytical code to test the simple question: *Irrespective of whether it was internally or externally acquired, does a scheme that ran a ‘Formal Tender’ get a different FM price to schemes that did not?* On the basis of the CMA’s data, the answer is that trustees do not achieve materially lower average prices if they run a formal tender. There is no statistically significant difference in FM price linked to using a formal tender compared to other ways of engaging and challenging FM prices. The analyses are set out in the Confidential Annex to this response.
- 2.4 One may expect a formal tender to result in lower prices. But we think the reason why the wider dataset does not show this may be due to the narrowness of the market testing that the CMA has focused on (i.e. “Formal Tenders” only). Trustees also exert pricing pressure on providers in other ways: through less formal testing (e.g. structured bidding processes); through the use of a Third Party Evaluator (**TPE**); or through an experienced professional trustee with knowledge of market

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<sup>1</sup> See the Mercer, WTW and Aon responses to the Provisional Decision Report (“PDR”).

<sup>2</sup> See Mercer response to PDR, page 16 paragraph 5.35.

prices. This was demonstrated in the CMA's own customer survey.<sup>3</sup> The widespread use of these alternative approaches may be achieving a similar effect on pricing in practice, in this highly competitive market place, to that of formal tenders at the point of selecting an FM provider.

- 2.5 It is for this reason that it should be for trustees to decide what form of market testing best suits their scheme in its particular situation.<sup>4</sup>

### 3 Impact of mandatory tendering – client experience

- 3.1 We appreciate that encouraging tendering has potential benefits. Trustees are responsible for appointing advisers and service providers across a wide range of activities, including professional advisers, administrators, custodians and asset managers. In our experience, clients obtain benefits in the following areas from carrying out a formal tender:

- (a) understanding the range of different service offerings available in the market;
- (b) requests for providers to consider the specific requirements of the scheme and how to help meet them;
- (c) comparison of capabilities and experience across market participants; and
- (d) benchmarking of fees for a defined level of service.

- 3.2 However, we also hear feedback from clients that there are times when they do not wish to carry out a 'full' tender, especially in relation to existing appointments:

- (a) Feedback from our clients is that 'full' tenders can be long and "painful" exercises. For clients who are already struggling with scarce trustee resources, the risk is that this obligation is a distraction and creates additional work and cost in running tender processes where the trustees may not consider this necessary or helpful.
- (b) This could be exacerbated by the risk of uncertainty among trustees about exactly when the obligation applies. The CMA is consulting separately on definitions of investment consulting (IC) and FM: we will respond to that consultation but there is a further issue around what constitutes a "tender" for these purposes (which is particularly important when considering the potential application of the obligation to existing appointments). The risk is that lack of clarity in the scope of the remedy creates additional complexity which requires trustee resources in the form of time and adviser costs to address – on top of running the tender itself.
- (c) Our most significant concern is that some schemes (especially smaller schemes) may be discouraged from considering FM at all if they would have to bear the cost of carrying out a formal tender before appointment. This could discourage schemes that would benefit most from FM.
- (d) For smaller schemes, we are concerned that a mandatory tendering obligation could in fact reduce choice. There is a risk that providers (especially smaller providers with constrained resources) will not respond or will only put in a "tick-box" response to some mandates – in particular smaller mandates or existing mandates (where the assumption is that the incumbent will be re-appointed).<sup>5</sup> This could lead to reduced competition for some mandates, especially those at the smaller end of the market.

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<sup>3</sup> The CMA survey found that trustees had made use of a number of methods of active engagement, such as: undertaking formal reviews of fees; benchmarking consultants' fees; commissioning external parties to assess fees; challenging consultants to improve terms; engaging a third party in the purchasing process for FM; and use of the scheme sponsor for external scrutiny (see e.g. sheets 48, 111 and 130 of the CMA's survey of pension scheme trustees, IFF Tables, All scheme types).

<sup>4</sup> See Mercer response to PDR, page 14 paragraph 5.24.

<sup>5</sup> See Barnett Waddingham response hearing summary, page 3 paragraph 15.

- 3.3 These concerns were reflected in the views of trustees at the CMA's recent roundtable, who raised doubts about the practicality of requiring formal tenders for existing appointments in particular, and suggested that 'comply or explain', amongst other things, might be a better alternative.<sup>6</sup>
- 3.4 We agree with this view. We believe that, in the appropriate circumstances, alternative methods of market testing may be equally effective (and more efficient) ways for trustees to test their options instead of running a formal tender. These could include, for example, appointing a TPE to carry out a benchmarking exercise to ensure the client is paying appropriate fees and receiving a high quality service. To allow this flexibility, we support a 'comply or explain' approach, which has been found effective in other contexts.<sup>7</sup> We believe that this approach, which is supported by a number of other parties in the market,<sup>8</sup> would achieve the CMA's aim of encouraging active involvement of trustees in testing the FM market in a more reasonable and proportionate manner.

#### 4 The CMA's revised results

- 4.1 We set out, in the Confidential Annex to this response, some more detailed comments on the CMA's approach to the economic analysis in the Updated WP. In summary, we still have concerns about the robustness of the CMA's analysis and do not believe it supports an AEC finding for the following reasons:
- (a) After correcting for the analytical coding issues identified by the parties in response to the PDR, the CMA's original engagement metric (defined as "Formal Tender, Professional Trustee, or Third Party Evaluator") would not have been statistically significant on any of the regression specifications originally shown in the PDR. In other words, the CMA's original analysis contained in the Gains from Engagement WP, if prepared without coding errors, would have shown that Internally Acquired Engaged clients did not obtain materially better prices than Internally Acquired Disengaged clients. Both the Static and Transition FM analyses, as consulted in the original Working Paper and PDR, would have found no detriment. We believe that to ensure the transparency of the CMA's analysis the CMA should confirm this position in the Final Report.
  - (b) The CMA seeks now to narrow the engagement metric to "Formal Tender Only" and further to exclude FM schemes with performance fees from the sample. This weakens the representativeness of the sample further and means that the CMA's reported results are now benchmarked against less than 3% of clients active in FM in 2016. Further the CMA's findings on this new metric are not robust to several small changes in the regression specification.
  - (c) When removing the "Internally Acquired" and "Externally Acquired" distinction to examine all schemes in the CMA's sample together, there is no evidence that schemes that undertook a Formal Tender received a different price to schemes that chose not to. No market-wide customer detriment can be linked to the CMA's new, narrower measure of engagement.

#### 5 Conclusion

- 5.1 In conclusion, the CMA's headline finding of a 22% fee reduction represents under 3% of the schemes in the market, and must be understood in this context. On a broader view there is no evidence of customer detriment. The CMA's finding is, therefore, an insufficient basis on which to find an AEC in FM or to impose a mandatory tendering remedy. We believe the CMA should instead consider a 'comply or explain' approach which would in any event be a more proportionate and effective method to achieve the CMA's stated aim of encouraging trustee engagement in choosing an FM provider.

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<sup>6</sup> Summary of trustee roundtable held on 3 October, page 3.

<sup>7</sup> See section 3 of Mercer follow-up submission to response hearing.

<sup>8</sup> See response hearing summaries of Aon (page 3 paragraph 11) and River & Mercantile (page 4 paragraph 23).

**Annex: Illustration of the CMA's econometric results**

- 1 The Updated WP corrects several coding and data issues in response to parties' comments on the results presented in the PDR. The CMA shows clearly (in column 2 of Table 2 and column 2 of Table 5 of the Updated WP) that fixing the data and coding issues would have led to no finding of gains from engagement in the PDR.
- 2 There would have been no customer detriment identified related to engagement in the PDR had the data and coding issues been addressed following the original Working Paper.<sup>9</sup>
- 3 The CMA has now also updated its original methodology: (i) it has narrowed the measure of engagement to "Formal Tender" only; and (ii) it has added in four new FM-only firms. While the latter step may appear to increase the CMA's sample size for analysis; in fact, we illustrate below why the final conclusions become less representative of the market as a whole.
- 4 The CMA's new 'baseline model' (i.e. its main scenario for analysis) is shown in column 1 of Table 3 of the Updated WP. It is based on a sample of 298 clients from 9 firms. This baseline model concludes that "Internally Acquired & Engaged (Formal Tender)" clients pay on average around 22% less than "Internally Acquired & Disengaged (No Formal Tender)" clients.
- 5 We set out the stages of the CMA's econometric analysis in this new baseline approach in the graphics below. Our advisers have expressed all the figures as a share of FM revenues in 2016, using the CMA's estimate of total FM market revenues of £255 million in Chapter 4 of the PDR.
- 6 The formal econometric analyses are contained within the Confidential Annex.

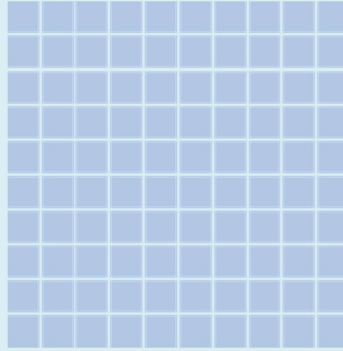
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<sup>9</sup> No confidentiality ring was opened at the time of the Working Paper; as such, parties did not have an opportunity to comment on these data and coding issues at that stage.

**Step 1**

The CMA estimates total FM revenue in 2016 to be over £250 million.

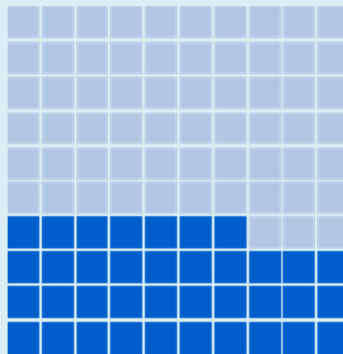
We represent this total market revenue with 100 squares.



**Step 2**

After data collection and preliminary cleaning, the CMA has a sample of 298 clients from c 700 clients in 2016, or around 37% of the total revenue in 2016.

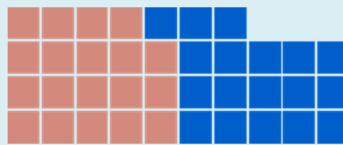
So the CMA's sample is 37 out of the 100 squares – shown shaded in dark blue.



**Step 3 (a)**

The CMA's sample of 37 squares splits almost equally between "Formal Tender" (19, pink) and "No Formal Tender" (18, blue).

The CMA defines only "Formal Tender" as engaged.



*No gains from engagement from a Formal Tender at the sample wide level.*

*The No Formal Tender group are evidently achieving similar outcomes, on average, to the Formal Tender group through other forms of market testing.*

**Step 3(b)**

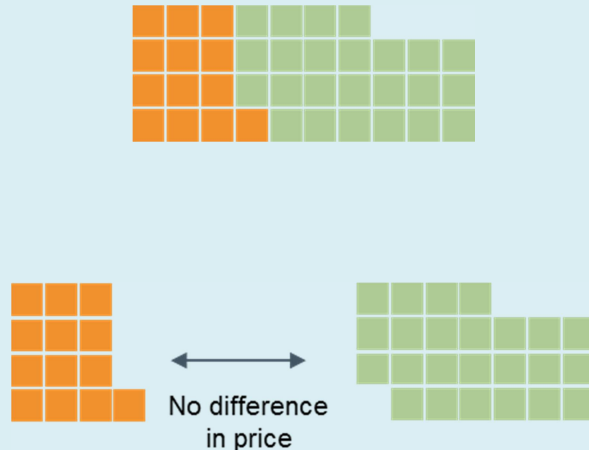


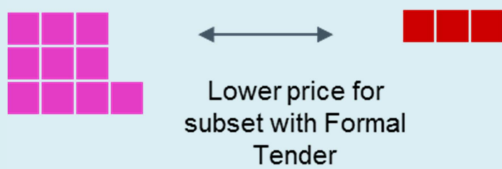
When testing whether any price difference can be found between the "Formal Tender" (engaged) and the "No Formal Tender" (not engaged) groups, no difference can be found.



**Step 4 (a)**

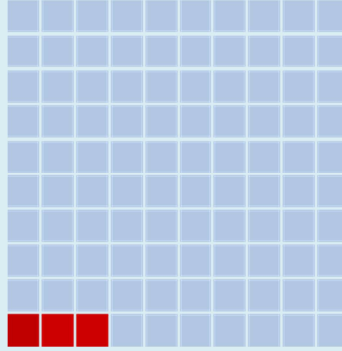
With no gains from engagement visible in the sample as a whole, the CMA sample of 37 is instead split between "Internally Acquired" (13, orange) and

*Internally Acquired clients do not receive a worse deal than Externally Acquired clients, even though Externally Acquired*

<p>“Externally Acquired” (24, green).</p> <p>Externally Acquired clients have clearly undertaken some market testing in moving to a new FM provider.</p> <p><b>Step 4(b)</b></p> <p>When testing whether any price difference can be found between the Internally Acquired and Externally Acquired groups, no difference can be found.</p>		<p><i>clients have all clearly engaged in some form of market testing in order to switch.</i></p>
<p><b>Step 5</b></p> <p>The Internally Acquired clients are then further segmented into “No Formal Tender” (not engaged) (10, purple) and “Formal Tender” (engaged) (3, red).</p>		
<p><b>Step 6</b></p> <p>When testing whether any price difference can be found between the “Internally Acquired &amp; No Formal Tender” group and either (i) the group of externally acquired clients or (ii) a combined group of engaged clients (externally acquired and those internally acquired with a formal tender), no differences can be found.</p> <p>So compared to the wider sample, the disengaged Internally Acquired group are not worse off.</p>		<p><i>No detriment compared to the wider market of engaged clients.</i></p> <p><i>So comparing against a larger benchmark groups, “Internally Acquired &amp; No Formal Tender” clients are not worse off.</i></p>
<p><b>Step 7</b></p> <p>But where a price difference can be found is within the Internally Acquired group of 13. When the 10 are benchmarked against the very small subset of 3 Internally Acquired &amp; Engaged there is a price difference; although this result is not robust to sensitivity testing.</p>		<p><i>Price difference found when benchmarking “Internally Acquired &amp; Disengaged” clients against a sub-group of just 3% of the market by revenue.</i></p>
<p><b>Step 8</b></p> <p>The CMA’s baseline result is fragile; for</p>		<p><i>The CMA’s baseline result depends on benchmarking against less than 3% of the market by revenue</i></p>

example, when:

- Removing the variable 'Percent in FM' actually increases the sample and benchmark group substantially but the CMA's result disappears.
- Reclassifying 'structured bidding processes' as part of the engaged group increases the benchmark group but the CMA's result disappears.
- Using the CMA's original engagement metric (Formal Tender, PT or TPE) removes the result.



*(fewer than 20 clients from over 700).*

*This a weak basis for finding market-wide detriment or enforcing market-wide mandatory tendering.*

*Particularly when this result breaks down when the comparator group increases (see steps 4 and 6) and there is no gain on average from Formal Tender (step 4).*

To respond to some of these concerns, the CMA removes clients with Performance Fees; but in fact this makes the benchmark groups even smaller (less than 2% of the market).