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Watchdog referral looms for investment consulting industry

By **Angus Peters** | June 29, 2017

Industry-led proposals to minimise conflicts of interest in investment consulting have been rejected by the Financial Conduct Authority, bringing firms a step closer to investigation by the Competition and Markets Authority.

In the final report of its asset management market review, the FCA revealed that the three largest consultancies – Willis Towers Watson, Mercer and Aon Hewitt – had presented "undertakings in lieu" in an attempt to head off the referral.

Subject to the provisional CMA reference, the regulator will ask the Treasury to include investment consulting in the FCA's remit.

Our thinking is that if we were to accept [the undertakings in lieu of the big three consultancies], it would only be partial market coverage

Mary Starks, FCA

Conflicts of interest among advisers, in particular the financial motivation for consultants to 'flip' clients into fiduciary management mandates, are a major source of concern for pension schemes and regulators.

Disclosure of fiduciary performance and fees, alongside regular tendering exercises for all investment consulting contracts, were included in the UILs submitted by the 'big three' firms.

Promises were not enough

The draft standards also promised that the companies would provide detailed information for the comparison of their manager recommendations with comparable mandates, and that they would maintain a policy on hospitality practices.

But the proposals were not enough to persuade the FCA, which will now pursue a more comprehensive solution to the flaws it raised in the study.

Mary Starks, director of competition at the watchdog, said that while the submissions were "thoughtful", they did not remove the impetus for an in-depth investigation across the consulting and fiduciary market.

The three firms revenues account for 56 per cent of the market, and their market share increases if clients' asset size is factored in.

"Our thinking is that if we were to accept that, it would only be partial market coverage," said Starks.

The rejection must now be subject to industry consultation, which will close on July 26.

Andrew Kirton, global chief investment officer at Mercer, said he was not surprised by the final report, but that he thought the undertakings were robust and competitive.

"They still feel they don't have a good enough understanding of the industry… to say that all of the concerns have been effectively addressed, and in that sense it's a bit disappointing," he said.

He said the FCA could have accepted the proposals, which would have resulted in more than half of the DB client base going to tender within five years, subject to full industry participation.

Focus on fiduciaries

While Kirton was happy with consultancies offering fiduciary management where conflicts are managed, others were more suspicious of vertically integrated business models.

Dan Mikulskis, managing director and head of defined benefit at consultancy Redington, welcomed the recommendation that all consultants are brought within the same remit.

He said that mandatory tender requirements could boost transparency, but that "the concern there is whether there is always the right level of competition when the mandate gets awarded".

Others were disappointed with the FCA's focus on the practices of fiduciary managers who previously operated as investment consultants, rather than the whole market.

"I think the key area around transparency is over performance measurement and it's ensuring that all fiduciary management firms adhere to a clear standard," said Richard Dowell, head of clients at fiduciary manager Cardano.

Meanwhile Danny Vassiliades, managing director at Punter Southall Investment Consulting, expressed frustration with the length of the consultative process: "There doesn't seem to be many concrete actions coming out of it."

Time to consolidate

Trustee boards did not escape the scope of the FCA's proposed remedies for the pensions system.

The regulator will ask the Department for Work and Pensions to address barriers to scheme consolidation and pooling for both defined contribution and DB schemes, in order to boost governance capabilities on trustee boards.

No all-in fee for asset management firms

Asset management firms must disclose estimated and actual fees and transaction costs to clients, but should not be forced to charge a single fee for services, the Financial Conduct Authority has recommended.

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It did however recognise potential difficulties arising from full DB consolidation.

"What's beginning to evolve is essentially a binary decision for some funds," said Patrick Disney, managing director of fiduciary manager SEI, saying the search for better outcomes was leading trustees to ask, "Do you merge, or do you hire an aggregator who gives you the benefits of merging?"

Neil McPherson, managing director at professional trustee firm Capital Cranfield, was not convinced fiduciary management would help in this respect. "I'm not sure how fiduciary management is an answer to consolidation," he said.

He welcomed the decision to involve the DWP in promoting consolidation, but warned that the complexity of merging DB funds meant it was "no silver bullet" to scheme underfunding.

He said that less disruptive solutions, such as pooling, could already be achieved and were only being held back in practice by vested industry interests and government-created complexity in DB rules.

How do trustees choose the 'right' consultant?

By **Sophia Imeson** | July 2, 2017

The Financial Conduct Authority's final report on the asset management market revealed that the investment consulting sector has not escaped the watchdog's scrutiny, but pinning down criteria for a good consultant is not easy.

The report, which was published last week, showed that the FCA is now consulting on whether to make a market investigation reference to the Competition and Markets Authority on investment consultancy services, having rejected undertakings in lieu provided by the three largest investment advisers.

"We are recommending that the Treasury considers bringing investment consultants into the regulatory perimeter, subject to the outcome of the provisional market investigation reference to the CMA," it said.

Understanding what exactly is required from a consultant carries some complexity, it won't boil down to a simple checklist

John Belgrove, Aon Hewitt

What trustees look for

The Pensions Regulator states that "trustees should have the right people to help them run their scheme", but choosing the right advisers is not always a straightforward process. When it comes to selecting an investment consultant in particular, trustees take a plethora of factors into account, and these can vary depending on the type of scheme.

A recent Aon Hewitt and Leeds University Business School survey asked nearly 200 trustees what they look for in fund managers and investment consultants. It found that the most important factors for trustees, when choosing an investment adviser, are common across all schemes regardless of size. These included the provision of clear advice, understanding the goals of trustees and comprehending the scheme's situation.

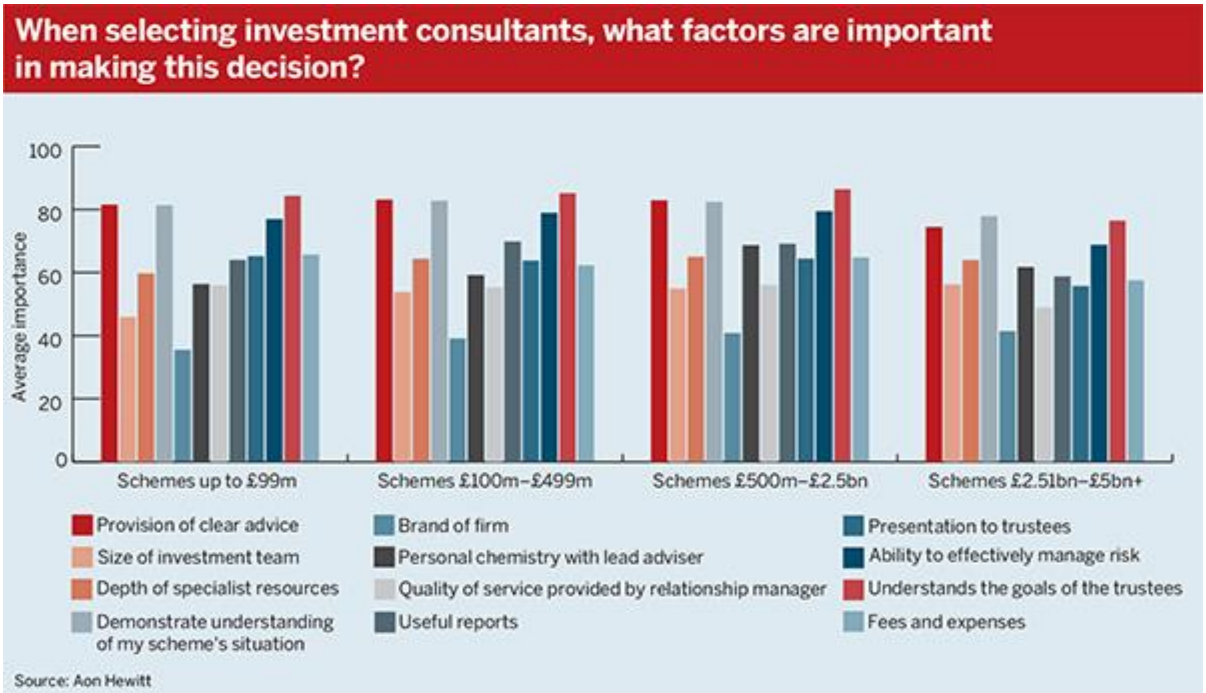
It showed that bigger schemes tend to be more focused on the size of investment team, depth of specialist resource and personal chemistry. Reports and presentations to trustees are higher-ranking factors for the smaller pension funds, as are costs and fees. This focus on costs is not surprising, given that many sizeable schemes often have a bigger budget.

Scheme size influences trustee decisions

John Belgrove, senior partner at Aon Hewitt, says that while there are exceptions, "on average, the larger pension schemes tend to have a stronger governance set-up" and "tend to have not just main committees but [also] subcommittees with dedicated experts… who generally are stronger on financial capability".

This is echoed by Christina Bowyer, director at independent trustee company HR Trustees, who says: "There is only so much buying power you have as a small scheme."

She argues that if "you've only got a certain amount to spend then clearly that has an impact on what you can have, and you have to be realistic on what you ask for when you review investment consultants".



There are a number of core elements trustees could look for in an investment consultant.

David Weeks, co-chair of the Association of Member Nominated Trustees, says that the "capacity to understand the scheme objectives and follow the guidelines that have been agreed by the trustees" are important, as is transparency about costs and charges.

Clarity regarding potential conflicts of interest is also a key concern, according to Weeks.

In its asset management market study, the FCA highlighted the "strong culture of gifts and hospitality in the investment consultancy sector which could influence the ratings given to managers".

It found that only around 23 per cent of investors use two or more consultants, and that smaller schemes tend not to have the resources to do their own due diligence to be able to challenge consultants' views.

So where exactly are the conflicts?

Belgrove argues that the industry has evolved to better understand and identify where conflicts exist and how to manage them.

But Giles Payne, a director at HR Trustees, notes that "there is an increased instance" in smaller schemes with a lack of trustee confidence and knowledge moving to fiduciary management.

The process of selecting an investment consultant, indeed any other adviser, isn't terribly sophisticated

Richard Butcher, PTL

He says that while some schemes benefit from someone else taking the steering wheel, "there is a very big incentive for the existing consultant to use their own fiduciary management expertise in that environment, so there's immediately a massive conflict there".

And if the trustees do not have the confidence to take the decisions, "they're not likely to go out and get a proper tender exercise done to find out who's most suitable for them", he explains.

Aon Hewitt's survey found that about 24 schemes of all sizes said they are completely reliant on their investment consultants.

Over-reliance on investment consultants is another area in which lack of trustee knowledge comes into play. Richard Butcher, managing director at independent trustee company PTL, says it could be caused by trustees not being "sufficiently experienced and knowledgeable enough to be able to set their own agenda or challenge their investment consultant robustly".

In a world where the predominant form of trusteeship is lay trusteeship, this is a common issue, and "lay trustees bring other skills but they don't bring technical expertise", Butcher says.

Reduce complexity

He argues that another reason for trustees being totally reliant on their consultants is that "investment consultants have a tendency to over-complicate".

And although many investment solutions may be very good, they may also be very complex, leading to trustees relying more heavily on their investment consultants.

Weeks also says that one of the things "trustees sometimes find irritating is consultants who talk in either opaque or obscure language or reliance on acronyms as though everybody will naturally understand".

He adds that trustees need "consultants and fund managers who can talk a straightforward language which the laymen on the board can understand".

Similarly, Payne says: "It's knowledge and it's lack of confidence as well, in that they don't feel they have the wherewithal to question or challenge, and I think that comes through quite loud
and clear."

Trustee knowledge and understanding was a key part of the Pensions Regulator's 21st Century Trusteeship and Governance paper published last year.

"There's been a general statement to say trustees aren't well equipped to challenge their advisers," says Belgrove.

However, he says it is important to take into account whether advice is being tailored to the individual needs of the scheme, because when "advice is highly tailored, you don't expect it to be pushed back so often".

No simple checklist

But there is no generic answer to the question of what trustees look for in an investment consultant.

Belgrove says: "Understanding what exactly is required from a consultant carries some complexity, it won't boil down [to] a simple checklist of, 'This is what makes a good consultant', because different clients want different things from their adviser."

In contrast, the survey shows that there is more clarity about what trustees want from asset managers – good performance on a risk-adjusted basis.

Investment consulting has developed over the years, changing to meet the needs of trustees.

Over the past five to eight years "it's really come into its own and evolved to meet the needs… of the marketplace", says Bowyer.

However, this has not necessarily improved the way in which trustees choose their advisers. Butcher says: "The process of selecting an investment consultant, indeed any other adviser, isn't terribly sophisticated."

He notes that trustees tend to buy on name, price and familiarity. "Those aren't necessarily the best criteria for selecting any service provider. What you need to do first of all is to establish whether they can deliver what it is that you need," he says.