Anticompetitive risks among asset management providers to Dutch pension funds

The Netherlands Authority for Consumers and Markets (ACM) has conducted an exploratory study into potential anticompetitive risks in the asset management market of Dutch pension assets.

The reason for this exploratory study is twofold. The first reason is the economic and public interest of this market. In the Netherlands, over 10 million people save with a pension fund for their retirement. Over 1,300 billion euros in pension assets is invested by asset managers. Second, there are indications that competition among asset management providers is distorted. Given the enormous magnitude of the market, distortions can have major financial consequences for the performance of the invested pension assets, and, by extension, for individual pension-fund participants.

The study focused on two potential risks:

1. The effect of (high) switching costs on pension funds' switching behavior;
2. The effect of the bundling of asset management and investment consultancy services on the pension fund's choice for an asset management provider.

In order to investigate these risks further, ACM has conducted interviews with market participants and experts. ACM has also requested data from Dutch pension funds to be able to conduct a quantitative analysis of possible consequences.

Two possible anticompetitive risks

The effect of (high) switching costs on pension funds' switching behavior

Description of the risk

Pension funds may be less willing to switch asset management providers if they are faced with switching costs (high or otherwise), even though switching could lead to lower asset management costs.

In addition to realized return, the level of asset management costs has a large impact on the financial performance of pension funds. Thus, the price of asset management is an important competition parameter.

The so-called "lock-in-effect", which switching costs (high or otherwise) may have, makes the price of asset management less effective as a competition parameter. As a result thereof, competitive pressure is reduced, and asset management providers are able to increase their margins on the cost price of asset management. This leads to higher asset management costs for pension funds.

Quantification of the risk

In order to quantify the possible effect of switching costs, ACM has compared the asset management costs of pension funds that have switched asset management providers with those that have not switched. Dutch economic research agency SEO Amsterdam Economics carried out this comparative study commissioned by ACM. In this study, SEO Amsterdam Economics took into account as much as possible the differences between the pension funds.

The comparison shows that pension funds that have switched asset management providers at least once pay, on average, between 6.7% and 8.3% higher asset management costs in the year of the switch. SEO Amsterdam Economics also established that pension funds that take out investment consultancy services and asset management services from the same provider switch asset management providers almost half as often as pension funds that do *not* take out investment consultancy services and asset management services from the same provider.

The effect of bundling on the choice for an asset management provider

<u>Description of the risk</u>

The pension fund's risk of bundling asset management and investment consultancy is that the interests of the pension fund and the investment consultancy provider are not fully aligned.

Pension funds that hire investment consultants for advice generally do so because these consultants have more knowledge and information. Hence, most cases involve knowledge and information asymmetry. Investment consultancy providers that also offer asset management could, through their recommendations, have an incentive to steer (either directly or indirectly) pension funds in the direction of their own company's asset manager.

This disrupts the level playing field among asset management providers. Pension funds may not or not fully be aware of propositions of other asset management providers as viable alternatives. Investment consultancy providers that also offer asset management services are therefore able to raise their margins on asset management services.

These two risks may also amplify each other. The switching costs that pension funds have to pay in order to switch asset management providers could be higher if they take out the asset management services as part of a bundle, for example because the investment consultant recommends the pension fund to invest in investment categories with higher switching costs, also offered by the asset manager of the investment consultant.

<u>Quantification of the risk</u>

Based on the requested data, it is revealed that pension funds often take out bundled asset management services and investment consultancy services. Approximately half of all pension funds take out bundled asset management services and investment consultancy services. Based on the same data, it is also revealed that those investment consultancy providers that offer asset management services as part of a bundle sell asset management services as part of a bundle with investment consultancy services to pension funds in 80% of the cases.

The quantitative analysis conducted by ACM shows that pension funds that take out asset management services as part of a bundle with investment consultancy services incur asset management costs that, on average, are 9% and 10% higher than pension funds that take out these services separately. This applies in particular to small and medium-sized pension funds.

These higher asset management costs cannot be explained by different choices that were made by the pension fund, such as investing in more expensive investment categories, or by the asset management provider's performance, such as realizing excess return. Furthermore, these higher asset management costs cannot be explained by characteristics of the pension fund that do not change over time, such as the board or the type of pension fund. However, this quantitative analysis cannot rule out the possibility that those pension funds that take out asset management services as part of a bundle perform better over a longer period of time, since the analysis was limited to the years 2012 - 2017.

Conclusions and recommendations

This exploratory study into the competitive landscape in the market for asset management services for pension funds has shown that:

1. Pension funds that have switched investment management providers incur asset management costs that are, on average, 6.7% and 8.3% higher in the year of the switch;
2. Pension funds that take out bundled investment consultancy services and asset management services switch almost half as often as pension funds that do not do so.
3. Pension funds that take out asset management services as part of a bundle with investment consultancy services spend 10% more on asset management services than pension funds that take out these services separately. This applies in particular to small and medium-sized pension funds.

One possible explanation for these higher asset management costs for bundled asset management services and investment consultancy services is that the switching costs are higher. Pension funds that take out asset management services as part of a bundle appear to switch asset management providers less frequently.

A second possible explanation is that the interests of investment consultants are not aligned with the interests of the pension funds that they consult. Investment consultancy providers that also offer asset management services could have the incentive to steer pension funds in the direction of their own company's asset manager. This may seem appealing to the pension fund as well. Taking out asset management services and investment consultancy services as a bundle may be a lot less expensive than purchasing asset management services and investment consultancy services separately.

A third possible explanation is that taking out asset management services bundled with investment consultancy services might benefit coordination between the investment consultant and the asset manager. Additionally, bundling can make customized services possible. These are benefits that pension funds and other market participants have mentioned. For small and medium-sized pension funds in particular, these benefits may outweigh the higher asset management costs resulting from bundling.

ACM was not able to establish whether or not pension funds conduct an *integral* and *quantitative* cost-benefit analysis of the bundling of asset management services and investment consultancy services. Given the anticompetitive risks mentioned above and the consequences on the performance of pension funds, pension funds have every reason to do so. Pension funds can use the results of this systematic comparison of the costs of asset management services with and without bundling.