ASSOCIATION OF PROFESSIONAL PENSION TRUSTEES

RESPONSE TO PENSIONS INVESTMENT REVIEW

Response submitted to Government call for evidence

by 25 September 2024

Call for evidence questions: Scale and consolidation

1. **What are the potential advantages, and any risks, for UK pension savers and UK economic growth from a more consolidated future DC market consisting of a higher concentration of savers and assets in schemes or providers with scale?**

Consolidation allows for greater investment in illiquid assets like infrastructure, which is likely to be crucial for UK economic growth and long-term returns.

This would impact retirement savings on several levels. First, and most obviously, a general improvement of commercial terms. Members would benefit from collective buying power, economies of scale, and efficiencies from have a more homogenised pensions landscape.

Second, it is expected that governance standards would improve. The expectation is the schemes and providers that remain post consolidation would be the best designed and well run, meaning that overall VFM and member outcomes should improve. Another governance related benefit would be fewer member pots, or at least fewer locations for those pots to exist, making undertakings such as the pensions dashboard easier to manage.

We note in Q2 below the ongoing role of DC Single Employer Trusts. Also, DC master trusts can benefit from scale and professional governance oversight, supported by a full time dedicated executive team. Scale will drive down costs for savers. TPR can meaningfully oversee master trusts through the authorisation regime in a way that is not possible for multiple single employer schemes.

Master Trust providers offer 'to and through' post-retirement solutions and guidance to members giving them better options at retirement with more easily accessible advice and guidance.

The potential downside could be market stagnation. If the post consolidation remaining providers become too similar and noncompetitive it could lead to a situation where innovation slows down as there is little incentive for providers to keep investing in their proposition and improving, notably in administration areas. It would be important to make sure the market remains stimulated and innovative.

Also, there is a need to consider the risk of over-concentration of assets in a few large schemes, which could introduce systemic risk. If one large scheme fails, it could have a disproportionate effect on the entire market. This should be acknowledged as a real concern in policy discussions.

2. What should the role of Single Employer Trusts be in a more consolidated future DC market?

Employers should be able to clearly demonstrate and justify why they need their own bespoke solution, rather than using a DC master trust. Many, subject to a thorough due diligence process, should be able to find an off the shelf solution that meets their needs.

However, Single Employer Trusts should remain a viable option for paternalistic employers who wish to maintain a certain level of control over their pension benefits. Schemes that have reached a critical mass of members and assets are able to achieve competitive terms and services and can afford the appropriate levels of advice and trustee support to maintain VFM and governance standards and should not be coerced into consolidation. Member outcomes should be at the heart of all considerations but there are still many Single Employer Trusts that are offering VFM and good outcomes.

The push for consolidation should be aimed at raising the standards of governance for those schemes that are currently not meeting them and offering a sensible path for those who aren't to join an appropriate alternative.

3. What should the relative role of master trusts and GPPs be in the future pensions landscape? How do the roles and responsibilities of trustees and IGCs compare? Which players in a market with more scale are more likely to adopt new investment strategies that include exposure to UK productive assets? Are master trusts (with a fiduciary duty to their members) or GPPs more likely to pursue diversified portfolios and deliver both higher investment in UK productive finance assets and better saver outcomes?

Note that for some insurance providers of GPPs, and very small insured trust-based schemes, there are significant concerns about the quality of administration. To the point where trustees cannot be confident at all that members' benefits are correctly recorded. In a DC arrangement errors compound massively over time and can be a nightmare to correct. Trustees need assurance that the insurance providers are sorting out these issues, taking these matters seriously and importantly that if those schemes are wound up, where most naturally this would involve assignment of policies to those insurers, that members will not suffer any detriment.

Master trusts should be the preferred solution, because of the enhanced governance offered by the fiduciary duties and powers of the trustees to make changes for both past and future. The key disadvantage of GPPs is the need for individuals to engage with their pension and take actions such as changing their investment fund or transferring to a more modern product.

The role of the IGC is very different to a trustee and should not be seen in the same light. An IGC must give an opinion on value for money. It does not have the power to make changes to charges, service providers or investment strategies – all those powers rest with the GPP provider and in many cases also require individual member consent or action.

Regulation

Master Trusts and contract-based schemes are regulated by different bodies and this impacts on the ability to invest in private markets. For example, in the contract-based world, regulated

by the FCA, the COBS rules restrict the amount that can be invested in illiquid assets when members are self-selecting their funds. No such restriction exists in the trust-based space.

Consolidation

Consolidation of member pots is a key tool to improve member outcomes. Given the nature of GPP market with individual contracts with a provider, consolidation is very difficult in this market.

4. **What are the barriers to commercial or regulation-driven consolidation in the DC market, including competitive and legal factors?**

The barrier to member pot consolidation, which has the potential to be more significant than market consolidation, is having a market mechanism to facilitate it. A 'pensions clearing house' is required to facilitate consolidation without placing significant burden on employers. A pension clearing house would also help address issues with data fragmentation and legacy systems which may present a significant challenge to successful consolidation.

Another key barrier is the one-off cost of the exercise to properly review the market and select a master trust and then arrange a bulk transfer to it. Nuances in individual scheme rules, particularly in relation to protection of benefits such as entitlement to lump sums and the ability to retire early, make these transfers more complex.

Winding up a DC scheme is not a cheap exercise. Whilst the ability to move to a Master Trust does really help this process, along with experienced professional trustees if on the Board, there are cases where own-trust DC arrangements do provide good value for members and the benefits of consolidation are limited. It is important that wider policy agendas without tested delivery are not blindly pursued when these may not necessarily be in the best longer-term interests of members.

Costs vs Value

1. **What are the respective roles and relative influence of employers, advisers, trustees/IGCs and pension providers in setting costs in the workplace DC market, and the impact of intense price competition on asset allocation?**

The workplace DC market has historically been focussed on low-cost solutions. This is understandable because members bear these costs but also resulted in default investment strategies largely focussed on cheaper passively managed asset classes.

One thing to consider is the structuring of the charge cap which restricts schemes from investing in higher fee asset classes such as infrastructure or private markets which tend to have better risk/adjusted returns but larger management fees.

Another possibility is to remove certain asset classes from the charge cap calculation or section off a certain percentage of the overall portfolio to which the charge cap does not apply i.e. "90% of your assets need to be under the charge cap" which would allow schemes, some room to invest in other asset classes with higher fee structures.

As new solutions are made available, there is emerging evidence that employers, when supported by the right advice are opting for strategies which are more expensive if they

demonstrate better member outcomes. However, it is yet to be seen the extent of this shift as the solutions are relatively new to market.

Trustees play an important role in pushing for better member outcomes and evolution of fund design by providers. They set default investment strategies in the workplace space which is where most members invest.

Providers play a large role in the GPP market, and they will ultimately determine the default strategies most members use in this space. There are a range of providers with differing commercial interests.

2. Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?

If by Government interventions you are thinking of some form of guarantee to support savers invest in riskier assets then this would need to be very carefully thought through, considering the best interests of members and the taxpayer (who are largely the same people).

If it is to help provide more access to a wider range of investment classes, then the market could provide the products, but it would be for Trustees/IGCs to consider if this was best for members.

Government needs to consider carefully whether UK investment is any better than a more diversified portfolio. If some factors are not directly financial (but lead to better public quality of life) then this will need to be viewed in a similar light to ESG factors i.e. taking the wider financial interests of members into account.

Paying in more contributions would also have a far greater impact on member outcomes than increasing investment returns.

Regulatory changes

Ideally GPPs and workplace savings would share the same regulator. IGC's of GPPs would have decision making powers in a similar way to Trustees to remove any potential conflict between savers interests and a providers business model.

The VFM framework needs to be reviewed to ensure it does not have the unintended consequence of discouraging investment in private markets through excessive focus on short term performance. While private markets are expected to outperform over the long term, they won't necessarily outperform public markets in each and every year. There is a risk the VFM framework results in herding to asset allocations heavy in global passive equity as these have done well over recent years.

More general financial education for workers would help them understand the benefits of pensions and investment ISAs and give them more confidence to invest in such assets for the longer term.

Investing in the UK

1. **What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?**

Net returns can be a tricky measure to use, particularly for newer funds with shorter histories and for markets which have fluctuating returns. It is generally accepted that chasing returns gives a lower long-term return than a "buy and hold" strategy. You need to convince people to buy the desired asset classes above the other options and also to hold them longer term.

That said, in a more consolidated market it would potentially be easier to mandate certain investment policies. Moving away from a focus on cost to net returns is sensible if risk is still factored into the decision-making process. DC members traditionally need a higher level of liquidity and stability during the decumulation phase as they approach retirement and certain asset classes do not lend themselves to this. It is unclear what impact this would currently have on UK domestic growth as schemes will still be looking to invest in the most competitive assets and UK assets have steadily underperformed against global alternatives in recent years.

We acknowledge that restructuring the pensions landscape to encourage investment in the UK economy, specifically in long-term infrastructure, could boost growth in the UK and thus the returns available in UK assets.

However, the issue with UK investment is not a lack of regulatory framework. The fundamental question is not "what can we do to make schemes invest in UK assets?" The question is "why are UK assets not currently attractive to invest in?" Allocations to UK equities have been in steady decline across virtually all investment strategies for the better part of a decade. This is because their performance, costs, and risk profile are not competitive when compared to the global market. Pension schemes are tasked with growing member pots, not fixing failings in the UK's economy. If we want to see more widespread pensions investment in domestic assets, they need to be more attractive. Otherwise, schemes will be putting the economy ahead of their duty to members, sacrificing their growth to prop up the economy.

What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?

Over the last 10 years greater focus has been put on the asset allocation decision as governance standards have improved. Global equites carry less concentration risk at the stock and sector level than UK equities. UK listed equities have also underperformed against their global equivalents and yet they often cost the same if not more and experience similar levels of volatility. Schemes have a duty to provide good member outcomes and growing member pots is a significant cornerstone of fulfilling this duty.

UK indices also have a higher allocation to higher emitting sectors which is challenging for schemes with net zero targets. Advisors have therefore typically guided schemes to invest in a more diversified global manner to reduce risk and improve member outcomes.

Historically investment into illiquid assets in DC has been limited due the fragmented nature of the market meaning many schemes did not have the size and scale required to invest. There has also been recent innovation in fund structures (e.g. LTAFs) which have facilitated

investment, and this is expected to continue to drive investment in these types of assets in the coming years.

To increase investment flows further innovation is also needed within asset managers, particularly private equity, where fee structures are both prohibitively high and structured in a way which is not necessarily compatible with DC investors objectives. There is a tension between performance fees and need to ensure members joining the scheme at different times experience the performance they are paying for.

The regulatory framework encourages schemes to lean towards lower cost investments. The charge cap of 075% is a key consideration when selecting funds. Certain asset classes, particularly illiquid assets, are generally more expensive pushing an investment strategy's aggregate cost closer towards the charge cap. In addition, VFM and several other reporting metrics such as the transaction costs and charges illustrations in chair statements place a focus on costs and generally reflect more positively on cheaper funds and services over more expensive yet better performing ones.

2. **Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?**

It would be difficult to mandate allocations to UK assets as a trustee has a fiduciary duty to ensure the best member outcomes and strategies should be designed around member needs.

For example, it would be inappropriate to invest in illiquid assets beyond retirement age if members continue to cash out and a high degree of liquidity is therefore required.

There is also a tension between reducing risk to members through investing in a globally diversified manner and investing in the UK.

There is an opportunity to make UK assets a more attractive investment to DC schemes, through innovation in fee structures and greater transparency. In certain asset classes like private equity there is also a structural problem of the private equity funds being relatively small compared to the large amounts Master Trusts will need to invest.

Trustees and IGCs need evidence that increased UK investment will produce good (at least as good as a more diversified portfolio) returns and improve local communities / UK living standards. To take more risk for an unquantifiable gain is unlikely to be in the best interests of members.

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