THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

INVESTMENT INNOVATION AND FUTURE CONSOLIDATION:

A CONSULTATION ON THE CONSIDERATION OF ILLIQUID ASSETS AND THE DEVELOPMENT OF SCALE IN OCCUPATIONAL DEFINED CONTRIBUTION SCHEMES

RESPONSE FROM THE INVESTMENT ASSOCIATION

28 MARCH 2019

SUMMARY OF IA RESPONSE

The Investment Association[1] (IA) welcomes the opportunity to provide input to the DWP's consultation on the consideration of illiquid assets and the development of scale in trust-based DC schemes.

We continue to emphasise the importance of ensuring that DC pension schemes are able to build fully diversified portfolios in order to realise their financial goals.[2] Pension scheme trustees should be in a position, if they wish, to allocate a proportion of their portfolios to illiquid assets, whose long-term nature should be very well suited to the investment horizon of pension investors. The additional diversification and illiquidity premium that these assets can offer could be of considerable benefit to long-term investors.

We note also the wider economic benefits that could arise if even a small proportion of DC capital could be allocated over time to assets such as infrastructure, real estate and private equity/debt. We are currently working on proposals to make it more straightforward for this allocation to take place through investment funds.

While investment has generally not been a high profile part of the discussion in the early years of automatic enrolment, we welcome the new emphasis on investment from Government and regulators as a result of HM Treasury's work on Patient Capital, in which the IA has played a full part, through our participation in the Pensions Investment Taskforce.

We respond in detail to the DWP's consultation questions below. There are three key messages in our response:

1. Illiquid investment reporting requirements. The overarching goal of DC investment is to invest in assets that will deliver adequate pensions to members. An allocation to illiquid assets may be part of that but is not an end in itself. Our concern is that the DWP's proposal could be interpreted as such. Illiquid assets can be part of a well-diversified portfolio but it makes little sense to single them out over other asset classes. Rather than a narrow focus on illiquid assets, the emphasis should be on the construction of well-diversified portfolios, with robust investment governance processes in place to ensure that such strategies are delivering for members over time.

The IA has previously suggested a governance approach to DC default strategy construction that provides a specific framework for investment decision-making and monitoring by scheme fiduciaries[3]. Rather than nudging pension schemes to invest in specific ways, the focus of the DWP and TPR should instead be to ensure that trustees are empowered to allocate to a wide range of assets in order to build suitably diversified portfolios. Given that UK pension schemes operate with few investment restrictions, this is about messaging, guidance and the right decision-making toolkits rather than legislative change.

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[1] The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage nearly €8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. More information can be viewed on our website.

[2] Putting Investment at the Heart of DC Pensions, The Investment Association 2018.

[3] See for example the IMA response to FCA CP14/16 'Proposed rules for independent governance committees' in which we discuss our proposal for DC default investment governance in detail. Much of the thinking in this approach has now been incorporated into TPR's DC Code and associated guidance on investment governance.

2. DC scheme consolidation. Scale in investment can already be achieved through investing in pooled funds, with the benefit that smaller schemes can access economies of scale in the investment process. For some small schemes, however, the benefits to members of high-quality governance may be achieved by consolidation into a smaller number of larger schemes that are able to dedicate greater resources to on-going scheme governance, including in relation to investment. The DWP should therefore move forward with its proposals to actively encourage smaller DC schemes to consider consolidation.

3. Charge cap issues. In keeping with our view that the DC investment emphasis should be on the construction of well-diversified portfolios, charging structures should not act as a barrier or impediment to allocating to particular asset classes. Whilst the charge cap does not currently preclude the use of performance fees, we welcome DWP's proposals to make it easier for trustees to monitor their compliance with the charge cap where performance fees are used.

IA RESPONSE TO THE SPECIFIC QUESTIONS RAISED IN THE CONSULTATION PAPER

FURTHER MEASURES TO FACILITATE INVESTMENT INTO ILLIQUID INVESTMENTS

Q1: We would welcome comments on the following proposals around reporting pension schemes' approach to investing in illiquid assets. We would also welcome any other proposals which use reporting to prompt consideration of illiquid assets.

(a) Scope: 'Relevant schemes' (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 or 20,000 or more members (or alternatively £250m or £1bn assets to provide for money purchase benefits) would be in scope of the proposed requirement. Would an asset-based or a membership-based threshold be more proportionate and effective?

(b) Reporting their policy: Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles

(c) Reporting their actions: Schemes in scope would be required to report annually on their main default arrangements' approximate percentage holdings in illiquid assets, and with a breakdown in holdings of the trustees' choosing.

1.1 We strongly support the need for a greater focus on the design and delivery of investment strategies in the DC market, as part of a wider consideration of 'value for money'. Low cost is increasingly synonymous with high quality, particularly in relation to investment. Our view is that quality can only be assessed by considering the objective – and the outcome – alongside cost. The Government's focus on helping DC schemes diversify their portfolios is therefore welcome, although we consider that the proposed approach is not the best way of achieving this, because of its narrow focus on illiquid assets rather than the degree of diversification in the portfolio as a whole.

1.2 DC scheme portfolios are less diversified in comparison to other investor types, with a lower allocation to illiquid assets. There are a variety of reasons for this, some of them regulatory, some a result of market convention and others the result of a demand-side that has been heavily influenced by the cost-driven focus of the auto-enrolment market. We have previously outlined how addressing these barriers will require a combination of regulatory and behavioural change.[4]

1.3 Through our work with HMT's Patient Capital Pensions Investment Taskforce and our responses to the FCA's recent consultations on patient capital[5,6], we have supported measures to help facilitate greater access to illiquid assets by DC schemes and other investors. The long-term nature of illiquid assets should be very well suited to the investment horizon of pension investors. The additional diversification and illiquidity

[4] Putting Investment at the Heart of DC Pensions, The Investment Association 2018.

[5] IA response to FCA CP18/40 Consultation on proposed amendment if COBS 21.3 permitted links rules, 2019.

[6] IA response to FCA DP18/10 Patient capital and authorised funds, 2019.

premium that illiquid assets can offer could be of considerable benefit to these investors as part of a well-diversified portfolio. To the extent that these investors are currently able to allocate less capital than they would like to illiquid assets, measures to increase their choice in this area are welcome and we support them.

1.4 However, we do not view an allocation to illiquid assets as an end in itself and our concern is that the DWP's proposal could be interpreted as such. Illiquid assets can be part of a well-diversified portfolio but it makes little sense to single them out over other asset classes. The danger of such an approach is that it could lead to some trustees making allocations to illiquid assets in isolation and without thinking about their function more broadly within the portfolio, with the possibility of an unsuitable exposure to illiquid assets the result. We therefore do not support an explicit reporting requirement on trustees in relation to their allocation to illiquid assets. We note also that many schemes will already report on asset allocation as part of the information they provide members on investment performance. It is not clear what useful information a further, separate reporting requirement in respect of illiquid assets would provide.

1.5 Instead of a narrow focus on illiquid assets, the focus should be on constructing well-diversified portfolios, which may include illiquid assets, and demonstrating through robust investment governance processes that such strategies are delivering for members over time.

1.6 The IA has previously suggested a governance approach to DC default strategy construction that provides a framework for investment decision-making and monitoring by scheme fiduciaries[7]. The approach – much of which has now been incorporated into TPR's DC Code and associated guidance on investment governance – aims to encourage scheme fiduciaries to set out member-focused investment objectives as well as providing details of the investment strategy that will be used to deliver this objective. This includes questions of diversification and asset allocation in the context of the overall strategy and is a more appropriate approach than simply focusing on illiquid assets.

1.7 The approach was originally designed to be used as a consistent reporting framework, but could take various forms, including guidance. The key aim is to ensure consideration of the investment strategy in the context of an overarching member objective. Illiquid investments may play a part in that and trustees and their advisers may choose to explore whether they wish to include them in their portfolios.

1.8 Rather than nudging pension schemes to invest in certain asset classes or according to particular management styles, the focus of the DWP and TPR should instead be to ensure that trustees are empowered to allocate to a wide range of assets in order to build suitably diversified portfolios. Given the relative lack of investment restrictions on UK pension schemes, this is more about messaging, guidance and the right decision-making toolkits than it is about legislative change. In that regard, we welcome TPR's comments and guidance for trustees in relation to illiquid assets and patient capital over the last year[8]. From a DWP perspective, a message that cheapest

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[7] See for example the IMA response to FCA CP14/16 'Proposed rules for independent governance committees' in which we discuss our proposal for DC default investment governance in detail.

[8] See https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes- and https://blog.thepensionsregulator.gov.uk/2018/03/12/pension-funds-and-illiquidity/

is not always best would be welcome, to counter the perception in some parts of the market that trustees' biggest risk is in relation to price[9].

1.9 Meanwhile the FCA's focus should be on ensuring that investment managers can meet pension schemes' demands for illiquid and other assets by ensuring an appropriate regulatory regime for authorised and unit-linked funds. The FCA's focus on illiquid assets and recent consultations on patient capital are welcome in that regard, although as we have indicated in our response to those papers, more work is needed in respect of fund structures and investment powers to ensure DC and other investors can gain exposure to a wider range of illiquid assets.

Q2: Do you think Government should encourage or nudge smaller occupational DC pension schemes to consolidate? If this should only happen at some point in the future what factors should be taken into account in determining that point?

1.10 While acknowledging that there are some very well-run small schemes and some poorly run larger schemes, the general trend towards DC consolidation is a positive one. While scale in investment can already be achieved through investing in pooled funds, the benefits to members of high-quality scheme governance may be more readily achieved by the market consolidating into a smaller number of larger schemes that are able to dedicate greater resources to on-going scheme governance, including in relation to investment.

1.11 Given the existence of a competitive market for master trusts and contract-based schemes, employers and trustees already have many options to achieve consolidation if they so choose. The quality of the master trust market will be further strengthened by the on-going master trust authorisation process. Where there are options available which will benefit members of smaller schemes, they should be able to benefit from these as soon as is practicably possible.

Q3: We would welcome views on the following proposals around pension schemes reporting their position on the potential benefits of future consolidation, or any other associated proposals.

1.12 We support the proposal for small DC schemes to consider formally at least every three years whether it might be in scheme members' interests to be transferred into another scheme.

(a) Scope: 'Relevant schemes' with fewer than 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.

1.13 The limits seem reasonable in targeting the appropriate group of DC schemes, although we expect TPR will be in a better position to advise on an appropriate series of thresholds on account of its supervision of trust-based DC schemes, through which it should be able to identify the broad characteristics of schemes whose members are most likely to benefit from consolidation.

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[9] Consistent feedback from IA members indicates instances of trustees being reluctant to increase their investment budgets by even a few basis points, on the grounds that any increase in costs is a bad outcome for members, regardless of the investment case for pursuing an alternative course to the benefit of members.

(b) What should be reported: Schemes in scope could be required to explain their assessment of whether it would be in members' interests to be transferred into another scheme with significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?

1.14 We agree that charges, investment, governance and administration are all important areas for consideration under a consolidation assessment. To this list we would add communications, as good communications can help drive member engagement in important areas such as contribution rates and decumulation choices, the latter of which has an impact on accumulation phase investment strategy in the years immediately before retirement.

1.15 We do not think a reference scheme should be used for comparison as a one-size-fits all approach is unlikely to be suitable for all members. A scheme-specific consideration of the matters described above would be more suitable, accompanied by some guidance on the factors that trustees should be considering.

(c) Reporting vehicle: The requirement could be added to the value for members assessment which forms part of the Chair's Statement and published annually.

1.16 We agree that the annual Chair's Statement is a suitable vehicle for reporting.

(d) Updating frequency: The explanation of whether it is in members' interests to consolidate should be updated at least every 3 years, and after any significant change in size or demographic profile.

1.17 An annual explanation should be required, as well as after any significant change in size or demographic status. We view the consolidation assessment as a natural extension of the annual value for money assessments and so think the former should also be completed annually.

Q5: What do you think about the use of indicators such as trustee knowledge and understanding, open or closed status or member demographics to identify and encourage schemes to consider consolidation? What indicators do you recommend and how could they best be communicated and verified?

1.18 While more granular approaches to identifying particular schemes may be desirable (trustee knowledge and understanding in particular seems an important factor in the context of concerns about scheme governance), this will come at the cost of requiring more intensive efforts by TPR to identify schemes. If the consolidation assessment is not too onerous, and extends naturally from the existing value for money assessments, then a simple threshold of scheme size as proposed may suffice.

ILLIQUID INVESTMENTS, PERFORMANCE FEES AND THE DEFAULT FUND CHARGE CAP

Q6: To what extent are performance fees used or required for funds which offer illiquid investment such as venture capital, infrastructure, property, private debt and private equity? Are market practices changing?

1.19 The use of performance fees is rare in 'mainstream' retail funds in the UK. However, we are aware that investment trusts and 'alternative' funds of the types listed in the question make considerably more use of performance fees.

1.20 Operating performance fees in open-ended funds is particularly challenging due to balancing the respective interests of incoming and outgoing investors with investors that remain invested throughout the period. Historically we have guided members as to the issues they should consider to achieve an appropriate balance in their performance fee structures. In contrast, operating performance fees in closed-ended vehicles is more straightforward because they do not need to deal with incoming and outgoing investors.

Q7: To what extent is the charge cap compliance mechanism a barrier to accessing funds which charge a performance fee? Does this act as a barrier to accessing certain asset classes?

1.21 As articulated in our response to Q1 the focus should be on constructing well-diversified portfolios, which may include performance fees, in order to deliver value for members over time. To achieve this it is essential that charging structures do not act as a barrier or impediment to investing in particular asset classes. Whilst the charge cap does not currently preclude the use of performance fees, their unpredictable nature means they are not compatible with the prospective method of monitoring charge cap compliance. Trustees prefer this method as it provides certainty that they will not breach the cap.

Q8: Do you agree that we should permit the additional method of charges assessment? Do you envisage any problems with complying with this method of assessment, or any reasons why it might disadvantage members?

1.22 In the interests of removing artificial impediments to allocating to a given asset class, we support the proposal to extend the way compliance with the charge cap is measured and the additional method of assessment is a reasonable approach.

1.23 In our understanding the additional method works by first using the existing prospective assessment to determine the headroom within the charge cap to accommodate a performance fee and then using an additional assessment to determine the performance fee parameters (e.g. fee rate, level of outperformance) that can be accommodated for a given allocation to the relevant assets.

1.24 Unlike the existing prospective assessment which gives assurance about ongoing charge cap compliance, the additional assessment does not give such assurance: the cap could be exceeded by higher than expected outperformance or a significant shift in the asset allocation in favour of the relevant assets.

1.25 Performance fees are usually calculated as a fixed percentage of any outperformance. Unless the performance fee in question is capped, trustees will need to develop a process for monitoring the level of performance fee accrued each time members are

able to leave the scheme to ensure they are not overcharged when taking into account the performance fee accrued in the redemption price.

1.26 Asset allocation will change over time due to the different returns of each asset classes. If the assets subject to a performance fee perform better than average within the portfolio, their allocation will increase. This will compress the level of performance fee that can be accommodated within the charge cap for that asset class. Therefore, unless the initial assessment is based on the maximum permitted allocation to the performance fee-bearing assets, trustees will need to develop a process for monitoring the asset allocation each time members are able to leave the scheme.

Q9: We propose that:

(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.

1.27 Performance fees are, by their nature, complex and there is a risk of unintended consequences in overly prescriptive rules and guidance. Given our understanding that performance fees are not currently prohibited, we would question the need to interject restrictions on their structures. If guidance is to be published we recommend it is principles based and focused on outcomes.

(b) We should in particular specify in statutory guidance that performance fees should be calculated and accrued each time the value of the fund is calculated.

1.28 In our view this is a necessary feature of performance fee structures in open-ended funds, which facilitate redemptions at net asset value, because it ensures redeeming investors incur their share of the performance fee when they redeem. Any other approach would concentrate that fee on the remaining investors.

1.29 Closed-ended vehicles do not allow redemptions at net asset value. Instead investors can exit their investment only by selling their holding to another investor either at a market price (as is the case for investment trusts) or a privately negotiated price (as is the case for non-listed closed-ended funds). In these situations the price might be at a considerable discount or premium to net asset value and it is therefore unclear how the performance fee accrual relates to the transaction price.

(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees.

1.30 It is our understanding that the existing charge cap rules do not prohibit the use of a performance fee; if this is the case a performance fee must be part of "an existing rights charge" defined as a charge calculated by reference to the member's rights under the scheme. DWP's proposals do not include permitting an additional type of fee and deal solely with the method of assessing charge cap compliance. Therefore it is perverse to further restrict the permitted charging structure as described in paragraph 63 of chapter 4. Performance fees are, by their nature, complex and difficult to compare and prohibiting their existence alongside a contribution charge or a flat fee will do nothing to simplify the overall charging structure. Moreover it would be wrong to influence asset allocation decisions based on an arbitrary view of what constitutes a complex charging structure.

UPDATED CHARGE CAP GUIDANCE

Q10: Do you believe that the updated non-exhaustive list of costs and charges provides increased clarity about the scope of the charge cap? Are there any areas where further clarity might be required?

1.31 The updated guidance does provide increased clarity.

1.32 We note the intention set out in paragraph 5 of chapter 5 and we understand the intention is to look-through to the charges of all underlying investment products for the purpose of the charge cap. However, the list of examples refers specifically to "UCITS, NURS and QIS". We would recommend using broader terminology such as:

"Ongoing charges for underlying investment products in investment portfolio, e.g. fee for holding units or shares in collective investment schemes, investment trusts or similar vehicles"

1.33 Additional clarity could be achieved by clarifying whether the lists of in scope and excluded items are intended to be indicative or exhaustive. In particular, there will be an extensive list of items that fall within the list of "costs attributable to holding physical assets" that are not listed, for example, service charges, costs of marketing of vacant space, failed transaction costs.