DWP/HMT Pension trustees Call for Evidence Policy Team
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5th September 2023

Dear Sir/Madam

RE: Investment Association Response to 'Pension trustee skills, capability, and culture: a call for evidence'

The Investment Association (IA)[1] welcomes the opportunity to respond to the DWP/HMT call for evidence on pension trustee skills, capability and culture.

Our comments focus specifically on two areas:

- **The call for evidence on how investment consultant advice impacts on the investment management profession**.[2] We cover advisory services provided by the consultants and how this affects the demand and supply of investment products and services, particularly in the private assets space. We also reiterate our call for increased regulatory oversight over the investment advice given to pension schemes in line with the recommendations of the CMA market investigation of 2017-19.

- **The application of trustees' fiduciary duty**, particularly as it applies to investment in private asset classes. Here, we make a number of observations around the operation in particular of the DC market and the impact both of a predominantly daily-dealing delivery infrastructure and the relentless focus on cost as the ultimate measure of value.

[1] The IA champions UK investment management, supporting British savers, investors and businesses. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base and manage £10.0 trillion of assets. The investment management industry supports 122,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers. The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.
[2] Paragraph 48 of the call for evidence.

1. Investment consultants and their impact on the supply and demand of private asset investment strategies

The investment environment that trustees operate in has become more complex over the last 25 years for a number of reasons:

- Changes to the nature of DB pension promises that have increased the value and complexity of liabilities e.g. inflation protection for deferred benefits and pensions in payment, survivor benefits etc.
- A greater focus on pension liabilities, in turn due to a greater regulatory and corporate focus on the need to better manage liabilities.
- A greater desire on the part of trustees to manage the volatility of both assets and liabilities.
- The shift in investment risk from the employer to the individual as a result of the DB-DC shift.
- Changes in regulation and developments in the capital markets that have seen pension schemes increasingly focus on areas such as sustainable investment and private assets.
- Changes in the macro environment which has seen schemes needing to navigate, at different points: turbulent equity markets; sustained falls in long term interest rates; the economic effects of the pandemic and the war in Ukraine; and most recently, the return of higher inflation and the associated rapid rise in both short and long-term interest rates.

Much of the innovation seen in institutional asset management over this period – for example Liability Driven Investment, Fiduciary Management, Target Date Funds, Diversified Growth Funds, and Long-Term Asset Funds (LTAF), to name a few – has arisen in response to a demand for more sophisticated products to deal with the more complex environment that pension schemes now operate in.

As this complexity has grown, consultants have been important in helping trustees evolve their investment strategies and portfolios. They are an important part of the value chain of investment management services in pensions, acting as a gate keeper, with the majority of new business opportunities for investment managers coming through investment consultants. In relation to their intermediary role between investment managers and pension schemes, consultants fulfil three important functions[3], as discussed in the following sections.

Advisers with an understanding of pension schemes' investment needs

The consultants' primary role is as an investment adviser to trustees. This covers a number of areas such as: helping trustees formulate their investment beliefs and developing their Statement of Investment Principles (SIP); advice on setting an investment strategy and associated asset allocation; advice on manager selection; helping schemes comply with

[3] This discussion covers only the investment advisory services provided by consultants. A number of consultants also provide fiduciary management services, in direct competition with some asset managers. The Fiduciary Management market was examined by the CMA in 2017-19 due to concerns over the conflict of interest that is inherent in consultants' provision of fiduciary services, with a series of remedies set out to address the issues found by the CMA.

relevant investment regulation. Consultants are well-placed in this role to identify and understand pension schemes' investment needs and, in doing so, to drive the development of new investment products by communicating demand to investment managers.

As this pertains to investments in unlisted equities and other private assets, consultants should be helping clients to understand regulatory expectations and requirements for considerations around private assets; how these asset classes will impact on the risk and return profile of a scheme's portfolio; helping schemes understand the liquidity implications of any allocation to less-liquid assets; and developing a liquidity management strategy. As this process translates into demand for private asset investment by trustees, it will help drive the development of new products and attract new entrants to the UK DC investment market.

The extent to which this happens will in part be heavily reliant on the consultants' understanding of: the broader regulatory agenda; the universe of private asset opportunities and managers; and the willingness to present such opportunities to clients. While we believe this is already happening to some extent, we note that the lack of regulation of consultants for some of the advisory services provided – discussed in more detail below – means it is difficult for regulators to set expectations on the scope of advice provided to pension schemes, and this may mean that progress is slower than hoped for by government.

Manager research and ratings
The manager research and ratings function is a critical service provided by the consultants. Besides assessing the performance of particular products and strategies, it also involves consultants conducting due diligence on investment managers, ensuring that rated managers meet minimum quality and operational standards in a number of areas, for example:

- Stability of organisation
- Consistency of investment process
- Investment research capabilities
- Access to portfolio managers
- Alignment of compensation and reward between manager and investor
- Variety of investment strategies
- Organisational values, culture and ethics
- Internal control and risk management frameworks

This manager research serves many clients and is efficient for both pension schemes and investment managers, as the depth of research undertaken could not be replicated at individual client level.

Manager ratings and recommendations are a significant driver of asset flows in and out of products[4], due to the influence exerted by consultants on the investment decisions made by trustees, and the scale of assets affected by their advice. For managers it is therefore important to get their products rated by a diverse range of consultants, including smaller firms.

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[4] This is based on the experience of investment managers but has also been confirmed empirically by the FCA in its Asset Management Market Study from 2016-17. See 'Asset Management Market Study, Interim Report: Annex 6 – Institutional Econometric Analysis'.

The importance of manager ratings and recommendations also has a downside in that it can sometimes inhibit product innovation on the part of investment managers, in those cases where consultants may not have capacity to accommodate a new product or manager that has yet to be rated.

As far as private assets are concerned, this could be a key risk in reducing the pace of demand, where consultants are coming into contact with new managers or products that they haven't yet rated. The impact of ratings on flows into and out of more established asset classes suggests that this is likely to be the case.

Acting as a broker for pension schemes during fee negotiations
The third key function fulfilled by consultants is as a broker, acting as an informed buyer of investment products for clients, negotiating on fees with managers. By acting in this fashion, consultants are able to pool client assets, bringing the benefits of scale to fee negotiations with investment managers. The industry consensus is that this is a role that consultants fill well.

One possible concern here is that it creates an incentive for consultants to demonstrate their value narrowly by focusing on fee reductions achieved, which is an easily measurable and attributable outcome. This may have its limits in private markets, where the resource-intensive nature of investment sourcing and management means that costs are higher and scope to negotiate over fees may be lower, due to capacity-constrained investment strategies and competition amongst investors globally, to invest in the best strategies.

There is a risk that if consultants feel less able to demonstrate their value on fee negotiations in private assets, it may lead to them being less likely to recommend products in this area.

The regulation of investment consultants
Since the FCA's Asset Management Market Study in 2016, the CMA's resultant market investigation into investment consultants in 2017-19 and more recently, the September 2022 gilt market turbulence, the issue of how investment consultants are regulated has been of increasing interest. While investment consultants do offer some FCA-regulated services, notably around recommendations for specific products, or the manufacture and distribution of their own investment products and services[5], it has been widely documented that there are some aspects of consultant advice to pension schemes – around investment strategy, asset allocation, manager selection – that are unregulated.

We have been calling for these activities to be brought into the FCA's regulatory perimeter since the Asset Management Market Study and CMA review[6], on the grounds that the unregulated advice provided by consultants to pension schemes covers both an enormous pool of assets and is critical to scheme outcomes.

Increased regulatory oversight over the investment advice given to pension schemes is a positive move that will give the FCA the ability to set conduct rules for the investment consulting sector, monitor the quality of advice given, and set broad expectations around the matters that such advice should cover. This last point is particularly pertinent to the

[5] For example, elements of Fiduciary Management services, DC default strategies created by blending external managers' funds, or 'white label' funds where the investment management is delegated to another manager.
[6] IA response to the CMA Investment Consultants Market Investigation – Provisional Decision Report, 2018

current conversation around private assets and the role that the consultants have to play in increasing pension scheme demand for them.

In calling for this expansion in the FCA's regulatory perimeter, we are conscious that any changes will need to be made carefully and in a proportionate fashion. Additional regulation would have a cost attached that, if not implemented carefully, could force out smaller firms and present a barrier to entry for potential new participants. So changes in this area should not be implemented in a way that inadvertently reduces competition.

2. Fiduciary Duty and trustee decisions around investment in private assets

Fiduciary duty underpins the entire pension system, with investment managers acting as fiduciaries on behalf of their pension scheme clients and trustees in turn acting as fiduciaries towards their members.

Our view is that fiduciary duty is generally well understood by trustees and their advisers, with the traditional view focusing on maximising risk-adjusted returns, but subsequently becoming more nuanced over time to take account of other financially material factors such as sustainability considerations, including climate change.

When trustees invest, they do so in order to meet their investment objectives, in line with their fiduciary duty. These objectives are typically set in relation to risk and return, and in the case of DB, often relative to liability benchmarks. Asset allocation decisions then follow to design portfolios that seek to deliver these objectives. We set out this process because it is important to clarify for the present discussion that asset classes are never selected in isolation, but always in relation to the scheme's investment objective. The question trustees will always consider is what impact a new asset class could have on the risk-return characteristics of their portfolio, and what this does to the likelihood of meeting their investment objective. When it comes to private assets, which are illiquid, the impact on the portfolio's liquidity profile and scheme/member liquidity needs will also be factors in the allocation decision.

The legal framework[7] under which trustees make these asset allocation decisions is permissive, with little in the way of restriction, beyond the rules that impose limits on Employer-related Investments (ERI). While the FCA's permitted links[8] rules – which cover investment in unit-linked insurance vehicles that are commonly used in the DC market – have historically imposed certain constraints on investing in illiquid assets, recent reforms to these rules have changed the treatment of illiquid assets and made it easier for unit-linked funds to invest in private asset classes. Recent amendments to the 2005 Investment Regulations requiring schemes to have a policy on illiquid investments within their Statement of Investment Principles (SIP) further strengthen the need for trustees to at least consider private assets.

Taking these recent changes to the permitted links rules and the 2005 investment regulations into account, we believe the legal framework and associated guidance under which trustees invest in line with their fiduciary duties, is both sufficient to make allocations to private assets, and supportive of doing so.

[7] Pensions Act 1995 and The Occupational Pension Schemes (Investment) Regulations 2005
[8] COBS 21.3. These rules only apply where the investment risk is borne by a natural person. This means the rules cover DC schemes, but not DB schemes, which also sometimes invest through unit-linked wrappers.

However, challenges remain to trustee decision-making in this area, which may be leading them to shy away from making private asset allocations, in a manner that could be seen as not being entirely consistent with their fiduciary duties, although these challenges are not caused by regulation. The barriers in question are the impact of costs and the demand for daily liquidity.

The primacy of low cost in DC investment decision-making
Pension trustees, like other investors, can be price sensitive buyers of investment services. This is understandable given that, all else equal, a higher charge directly reduces the level of return. At the same time, what is most important to investors is the net-of-fee return and ultimately, investment decisions are made on an expected risk/return basis, with fee levels being reflective of factors such as management style, investment strategy/asset class and mandate size. Fees are typically subject to negotiation between managers, schemes and their investment advisers. With many different managers and investment products to choose from, this is a competitive market, with attractive pricing for pension schemes with a range of budgets[9].

However, as has been extensively documented[10] this price sensitivity is much higher in the DC market, with investment mandates regularly won and lost over handfuls of basis points. With any investment product, it is always the case that the management fee is certain and known ex-ante, but the future returns are unknown. Yet for reasons that are unclear, price seems to bear a greater weight than expected returns in the DC investment decision-making process compared to DB. This may be because members bear the direct cost of investment, as opposed to DB where in the first instance it is the pension scheme, and ultimately the sponsoring employer, that bear the cost.

This is a feature of trustee decision-making that merits further investigation to fully understand the drivers. Given the inherently higher cost of private assets (which arise due to the level of resource required to source and then manage investments on an ongoing basis) a greater emphasis put on price in decision-making will always act as a constraint on allocations to private assets.

Pending further investigation, one option to consider would be to give trustees a safe harbour over the selection of investment products for DC members. By shielding them from any legal liability for making allocations to more expensive asset classes that subsequently do not deliver on their return objectives, they may gain greater confidence when allocating to private assets.

Trustee appetite for daily liquidity
The other area we highlight as a possible barrier to allocations to private assets is trustee demand for liquidity. Traditionally this has been more of a challenge for DC schemes[11], due to the daily priced and traded environment that characterises the DC operational architecture. Although there are regulatory requirements around the prompt processing of schemes' financial transactions, as well as contractual terms between schemes and members that effectively promise daily liquidity, there is no wider regulatory requirement to do so. It has become a cultural norm and operational convenience.

[9] LCP Investment Management Fees Survey 2022, LCP
[10] Including most recently by the HMT/Bank of England/FCA-led Productive Finance Working Group
[11] DB schemes have generally been able to access illiquid assets more easily than DC, due to the lack of member ownership over the assets meaning that daily pricing and trading is less important. DB schemes' liquidity needs are driven more by scheme maturity (i.e. the extent to which money is needed to pay pensions in the short term) and the need to raise collateral against changes in the value of derivative and repo exposures in LDI strategies.

Any requirement for daily pricing and trading is clearly challenging for infrequently traded and priced investments and this has historically been a barrier to DC schemes' ability and appetite to access private assets.

However, the liquidity challenge is not insurmountable, and the development of new investment structures such as the LTAF, alongside greater information and guidance for DC schemes on liquidity management in the context of liquid and illiquid assets forming part of the same portfolio, is giving schemes the tools to overcome the barriers posed by a lack of liquidity.

As new illiquid products are launched and more schemes work through the operational challenges of less liquid allocations, our assessment is that the liquidity barriers to investing in private assets will reduce.

There is, however, scope for policymakers to speed this process up by re-setting the norm around daily dealing. This could take the form of an explicit and stronger statement from regulators that pension schemes should consider the appropriateness of daily liquidity over the course of a pension investor's lifetime. Such an approach would likely lead to different conclusions than today about the need for daily liquidity. In that regard, we strongly welcome TPR's recent update to its trustee guidance[12], where it makes precisely this point. TPR should monitor the impact of this change on trustee demand for daily liquidity.

We note also the operational barriers to illiquid allocations in DC. These centre on compatibility of illiquid fund structures with DC platforms, the challenges around pricing and rebalancing, and the need for DC schemes to have sound liquidity management policies. While a lot of good work has been done in this area to help trustees overcome some of these operational challenges, most recently by the Productive Finance Working Group[13], we encourage the FCA to echo TPR's messaging in relation to DC life platforms, which remain the key route through which UK DC schemes access investment products.

I hope this response is helpful and I would be happy to discuss further.

Yours Sincerely,
Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

[12] DC investment governance, TPR, updated August 2023. In relation to liquidity, the guidance states that *"Most members will not have a need for immediate liquidity of their investments, and it may not always be beneficial for dealing to be carried out daily. You should think about the level of liquidity that your members need, e.g.in relation to likely transfers from the scheme, and in that context consider the liquidity constraints on certain fund structures. You should seek to balance the liquidity of assets against the investment objectives. Holding too high a proportion of liquid assets may impact the level of investment return, and limit opportunity for diversifying your portfolio of assets."*
[13] Investing in less-liquid assets – key considerations, Productive Finance Working Group, 2022