PENSIONS AND
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ASSOCIATION

PLSA RESPONSE: INVESTMENT INNOVATION AND FUTURE CONSOLIDATION

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About the PLSA
We're the Pensions and Lifetime Savings Association; we bring together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses, including asset managers, investment consultants and other service providers. Our mission is to help everyone achieve a better income in retirement.

Introduction

We welcome the opportunity to respond to this consultation. The PLSA has been involved in several recent government debates on related issues, including our contributions to the Patient Capital work led by HM Treasury; we had a role on the *Pensions Investment Taskforce* and also produced some practical member guidance on *Patient Capital and Illiquid Investments* in December 2018.

We support government efforts to create a regulatory and policy framework which enables schemes to invest in a wider range of assets. It is important that barriers to different investment approaches are reduced where possible to allow schemes to invest in line with their fiduciary duty to members.

We welcome the statements from government in this consultation paper that pension scheme trustees must always invest to deliver an appropriate return to their members. We also appreciate that the chosen approach, as with the recent positive changes to the *Occupational Pension Schemes (Investment) Regulations,* focuses on using greater disclosure and transparency to 'nudge' scheme trustees.

Schemes must be allowed to invest in particular ways or in specific asset classes only where it supports their broader objectives to invest in the best interests of members. In the case of illiquid investments specifically, we believe that schemes are often particularly well-placed to benefit from the 'illiquidity' premium, given the long-term nature of their investment horizons.

This consultation to stimulate the appetite of Defined Contribution (DC) schemes for illiquid investments follows, as the paper acknowledges, the government's work to break down the barriers for Defined Benefit (DB) and DC schemes to invest in high growth, innovative firms and other patient capital approaches, as well as government work to *Grow a Culture of Social Impact Investing in the UK* which includes a focus on stimulating scheme appetite for impact investment approaches. Recent years have also seen the creation of 8 large investment pools of LGPS funds in England and Wales; when this was announced, the then Chancellor of the Exchequer George

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Osborne spoke about the government's "wider ambition to match the infrastructure investment levels of the top global pension funds".

Many pension schemes do indeed invest in housing, infrastructure, venture capital and illiquids. What pension schemes need is a coherent overarching policy and regulatory framework which supports them in investing in accordance with trust law and with their fiduciary duty to members. Although beyond the scope of this paper, given how much movement there has been from policymakers in the last five years to stimulate specific investment approaches, we would like to take this opportunity to ask for greater clarity from government on their approach to providing a coherent policy and regulatory framework on scheme investment which is in line with trustees' duty to invest in the best interests of members.

It is also important to note that scale should not be an end in itself. Although we agree that there can be many benefits to scale in terms of governance, access to expertise and the availability of particular investment approaches, it is quality – not the size of the scheme – which matters. We know that scheme members often feel more connected and appreciate being part of a smaller, well-run workplace scheme.

We would like to express our thanks to the government for their willingness to engage with us and our members on this issue. Our response builds upon these discussions and meetings as well as drawing on further feedback from our members and our previous work on Patient Capital.

Our response

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' with 5000 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 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.

We welcome the affirmation from government that pension scheme trustees must always invest to deliver an appropriate return to their members – it is important that this freedom to invest in best interests of members is maintained. We therefore appreciate the approach taken, which focuses on using greater disclosure and transparency to increase awareness amongst scheme trustees of illiquid investment approaches. However, there are concerns from schemes that, in the wake of new requirements to report on consideration of financially material ESG factors, stewardship and now illiquid investments in their Statement of Investment Principles, it is hard to anticipate future reporting requirements on other areas of scheme investment.

It will be important to ensure that the new regulations balance achievement of the policy objective with ensuring proportionality of new requirements on schemes. With this in mind, we support the government's intention to allow some flexibility to schemes in terms of requirements to report "approximate" holdings in illiquids and in the level and categorisation of this breakdown. Both schemes and their asset managers (or those responsible for providing the data) will also need greater guidance from government and regulators regarding what constitutes an illiquid asset. The current definition used (i.e. assets which are traded off-exchange or are less readily tradeable) leaves it unclear how, for instance, Real Estate Investment Trusts (REITs) should be considered and categorised by schemes.

To support implementation of the proposals in this regard, we would also urge the government to encourage asset managers to a) provide the necessary information on level of illiquid holdings in their funds in a timely fashion and b) provide the information clearly. Schemes have had concerns about the quality and clarity of other investment information provided to them by their managers – for instance, costs under the MiFID II requirements – but must rely on their service providers in this respect. It would also be helpful if steps could be taken to encourage asset managers to provide the information in a standardised format, perhaps through the provision of regulatory guidance in this area.

We agree with the government that, although the assets under management (AUM) may vary, there may be a significant disparity between the number of members (and the level of assets under management that may imply) and the actual assets under management. Given that the AUM is particularly pertinent in terms of impact upon the scope of investment approaches, we believe it makes more sense to base any threshold on the level of AUM.

The market for illiquid and patient capital investment approaches will no doubt continue to evolve. However, it is already possible for schemes to invest in illiquids via Diversified Growth Funds

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(DGFs), which offer a blend of asset classes and approaches. If the assumption underlying the current policy proposals is that there are benefits to encouraging a broader range of schemes to consider illiquid investments, then the threshold of £250 million seems appropriate.

We welcome acknowledgement that it will be harder to measure the level of illiquid investments in pooled vehicles or blended funds. We know that this will particularly be the case for schemes with fewer resources – and who are likely to have exposure to illiquids in this way. Trustees will, of course, have a duty to provide clear instructions to managers regarding the level and type of information they would like. Again, however, the onus must be placed on encouraging asset managers and platform providers to collect and give this information in a clear, timely and consistent way to trustees.

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? *And* 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.

a) **Scope: 'Relevant schemes' with fewer than 1000 members (or alternatively less than £10m in assets to provide money for money purchase benefits) would be in scope of the proposed requirement**
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 significant more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?**
c) **Reporting vehicle: the requirement could be added to the value for members assessment which forms part of the Chair's Statement and is published annually.**
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.**

The PLSA seeks to increase the quality and performance of workplace pension schemes. Large scale schemes tend to score more highly on these tests, so we welcome the current trend towards consolidation. However, smaller schemes may also deliver some or all of these benefits, so scale should not be pursued as an end to itself.

Our work in *Hitting the Target* examined the vital role transparency can play in enabling governance bodies to understand how schemes are performing on a range of issues, including value

for money. To this end, we recommended that "where pension schemes and providers to not deliver value for money, they should consider whether they can improve their performance or if it would be better to transfer members to another scheme or provider and wind up."

Similarly, our DB Taskforce *Final Report: Opportunities for Change* proposed a requirement on schemes to demonstrate to the Regulator that they are operating efficiently through a DB Chair's Statement, along the lines of those produced for DC schemes. Our proposal envisaged reporting on specific issues including whether or not a scheme could achieve better value for money through consolidating into a larger vehicle.

We note the similarity with the government's proposals for DC schemes in this paper. However, we would encourage the government to make it very clear – through guidance or messaging – that consolidation is only one of a number of possible options considered by schemes in their broader consideration of how to achieve value for money. Any guidance should also include prompts to trustees to consider the full range of implications of, for instance, any potential change in the nature of the administration costs arrangements[1] – or who would bear the costs of any merger into a larger entity. The provision of case studies in trustee guidance would also be helpful, as it would support a standardised approach across schemes and minimise the burden on schemes.

Our final point on what guidance should cover is the need for schemes to consider how they best align the use of illiquids to individual scheme members' profiles as well as their own cashflow needs. The importance of communicating clearly to members any changes in the framework around individual pots should also be highlighted.

Although we recognise the findings of The Pensions Regulator[2] that indicators of poor governance can be more concentrated amongst smaller schemes, we would emphasise that it is poor quality scheme governance and investment approaches which matter and not size. Any government regulation or intervention must be designed with this in mind as far as possible (though we acknowledge (see below) some of the practical difficulties in designing policy triggers based upon levels of Trustee Knowledge and Understanding (TKU) or similar).

If the government decides to use a size-based approach to the application and design of thresholds, we believe that for consistency's sake an AUM-based distinction is sensible.

Q5. What do you think about the use of indicators such as TKU, 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?

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[1] It is usual in the DC world for employers to bear administration costs, whereas the arrangement differs upon entry into the master trust. Any increase in costs does, of course, have an impact on the value of members' savings.

[2] For further information, please see TPR's *21st Century Trusteeship and Governance Discussion Paper* (July 2016)

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We agree that using TKU as an indicator may be difficult to implement, for the reasons explored in the paper. It is also the case that even though having good levels of TKU are vital, there are other factors beyond technical knowledge that contribute to good scheme governance, including the ability to engage and communicate effectively with members and the cognitive diversity of the scheme board.

Of the other options outlined, closed schemes are good candidates for consolidation and as an indicator 'closed or open' is easier to define and verify.

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?

There remains significant use of performance fees in the illiquids space – particularly for funds in private equity, venture capital, private debt and infrastructure. Many of the property funds used by schemes do not charge a performance fee. Although there are now some illiquid funds aimed at a DC audience which do not charge performance fees, these remain small in number.

As recognised in the consultation paper, schemes see value in well-structured performance fees as this can work to align asset managers' interests with those of their clients. However, there remain issues with the way in which some performance fees are structured. These include instances where the performance fees are based on a time scale that is too short – despite the shift in public policy and investor sentiment towards long-term investment approaches – and where the performance fee is not based on the performance which accrues to an individual investor.

We believe that the asset management market will continue to evolve over time, with more asset managers finding a way to offer fixed fee fund management where variable performance bonuses are consolidated smoothly within a fund.

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?

We strongly support the charge cap on default funds and believe it has been a positive step in ensuring greater value for money for members. We welcome the government's commitment to maintaining the cap at its current level.

Members responsible for advising schemes on their investment tell us that their understanding of the charge cap as it currently stands does indeed mean they are less likely to recommend use of a fund with a performance fee in a default fund (except in circumstances where there is an agree maximum on the performance fee that can be paid on the underlying fund).

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Although we believe that innovation in fund structures is encouraging greater predictability, we therefore welcome greater clarity for schemes in considering performance fees when assessing compliance with the charge cap. We do have concerns that there may be a tension between bringing in this additional methodology and ensuring that members can understand the approach to costs and charges undertaken by this scheme.

Furthermore, although out of scope of this consultation, we believe that there are other issues which contribute to the 'crowding out' of more sophisticated investment strategies within the cap. Pension schemes have, for instance, expressed concerns about the lack of transparency amongst administration providers on their charges despite trustees' best efforts to ascertain whether they are achieving value for money in this area; this may mean some schemes pay a significant amount for administration services, leaving less scope within the charge cap for investment and governance costs. We believe that this is an area which would merit further exploration by government and regulators.

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?

We think that the additional method proposed makes arithmetical sense. We would like to draw the government's attention to particular circumstances which may need to be taken into account when assessing compliance.

For instance, it is possible that, for blended funds (consisting of a mixture of illiquid assets – with performance fees – and other more liquid funds) the ratio of the components may change depending on market conditions and investment returns. If illiquids were to perform well, and we entered stressed market conditions, the normal act of reducing the allocation to illiquids could be rendered impossible if funds exercise their gate provisions. This could mean that the fund allocation to illiquid ends up much higher than expected and that a fee structure that had been compliant with the charge cap at the outset may not remain so. The probability of this happening reduces if the allocation to illiquid assets is kept low.

Given that many industry experts and commentators believe a downturn is likely in the near future, we would urge the government to bear this in mind when designing the final regulations.

Q9. We propose that:

a) **We should publish guidance – which might carry statutory weight – on appropriate performance fee structures**
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**
c) **Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees**

On a) we believe that trustees benefit from receiving information which is standardised as much as possible. We would welcome statutory guidance for managers on the appropriate performance fee structures. We believe that putting this guidance on a statutory footing would act as an appropriate incentive for asset managers.

On c) we agree with the principle that the time is not right for introducing further complexity into the charging arrangements, given the significant level of regulatory and industry change on costs and charges disclosure. Simplicity is necessary to ensure clarity and comparability for both schemes and scheme members.

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?

We agree that the additions to the list are helpful.

Q11. We would welcome views and any estimated costing for the impacts of these proposals.

a) **Stating a policy on illiquid holdings**
b) **Reporting on illiquid holdings**
c) **Considering and reporting on whether it might be in members' interests to consolidate**
d) **The additional method of assessment with the charge cap**

Please see our answers to previous questions.

We hope that the above has been helpful. We are happy to answer any queries or provide any further information.

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