PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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**RE: OPEN CONSULTATION: BROADENING THE INVESTMENT OPPORTUNITIES OF DEFINED CONTRIBUTION PENSION SCHEMES**

I write to respond to the recently published consultation on the draft regulations and guidance on exempting performance fees from the charge cap and the government's disclose and explain requirements in relation to illiquid investments. As you will be aware, we responded in January this year explaining in detail our members' views with regard to the proposal to exempt certain performance fees from the DC default fund charge cap. At that time we were sceptical about the potential for this measure to engender any meaningful increase in allocations to private markets and 'illiquid' assets – and any potential consumer upside, especially when weighed up against the risk of diluting the fundamental consumer protection the cap provides. Overall, the position of PLSA members has not changed since then, so we are disappointed the government has decided to go ahead with these plans, as outlined in the draft regulations. For these measures to be feasible and beneficial in the future we consider the following points need to be addressed.

## *Suitability of Illiquid assets for defaulted savers*

The charge cap provides essential security for the savings of millions of unengaged pension savers. Through the success of auto-enrolment, many of these savers are in pension schemes without any real understanding that their money is invested in risk-seeking assets at all, and so it is vital they are protected from those savings being invested in an overly risky and costly manner without their knowledge. The charge cap provides this assurance for that majority, who remain in default funds, and it helps prevent their pots from being gradually eroded by excessive fees.

We are also unconvinced that the overall ambition to increase allocations to illiquids would result in either greater returns for pension savers, or greater investment in – specifically – UK infrastructure, property and businesses, as per the government's growth agenda. Even were trustees to utilise the performance fee exemption, it would be the responsibility of their fund manager to identify the best private markets potential for outperformance, and our members tell us this would more than likely proportionately benefit global funds, due to the broader opportunity set this gives DC savers. Furthermore, recent market activity has resulted in above average volatility in pension funds – particularly problematic for DC members approaching retirement. It is therefore vital trustees retain full independence of decision-making when faced with such complexity, especially when more investment in riskier assets raises the possibly of even greater swings in fund performance, which may be counter to the best interests of defaulted AE savers.

As a final point, DC schemes are increasingly adopting drawdown as their default investment strategy, but few are in a position to provide drawdown in-house. This means members would typically be de-risked out of any illiquid assets before retirement and need to transfer their benefits to an alternative arrangement to access drawdown (which often results in transition costs). These transfers of assets can be avoided with a "to and through" retirement strategy, however currently only those master trusts or contract-based schemes with large employers and non-transient workforces provide such solutions. If reforms to the current decumulation system following the government's Call for Evidence led to more schemes offering such solutions, more savers could potentially benefit from the continuity of investment and longer-term investment horizon into decumulation. Similar principles apply to pooled vehicles, such as CDC schemes, which essentially extend the growth phase indefinitely so could provide greater opportunity for illiquid investment than DC, an aspect to be explored in the upcoming consultation on multi-employer CDC.

### *Cost/benefit of performance fees and illiquids*

Regarding the criteria for fees to be exempted from the cap, we see a direct link to performance as an absolute minimum, i.e. no fixed fee element may be automatically classed as 'well structured'. This approach remains, however, a watering-down of the current protection regime, and for this reason we would like assurance that this doesn't represent a first step, with possible further reductions to member protection to follow, especially for default funds. Similarly, we agree with the draft regulations stipulating the need for trustees to agree in advance with their fund managers, the nature and time periods the fees will apply over (paragraph 136). However, we are concerned about the cost implications of the suggestion that trustees will be expected to seek further guidance from advisers (paragraph 137). The draft guidance (paragraph 78) also implies an increased dependence on advisers with regard to the fair treatment of joiners and leavers to ensure members only pay for the performance they've benefited from. Again, the overall consequence will be additional running costs for schemes, which must be borne in mind when considering any potential for net investment outperformance and, ultimately, value for members.

### *Existing – and remaining - barriers*

Whilst we agree that economic growth is a key priority, investing long term savings – including pensions – in illiquid assets, has long been a concerted and specific initiative pursued by government that has had mixed success to date. For example, as the Productive Finance Working Group identified, there is no one solution that will 'unlock' more investment. As such, we need to remain mindful that other major barriers remain, even if certain fees can be excluded from the charge cap.

- One key factor is that **master trusts**, which cater for a large part of the AE market (around £53bn of assets[1]) operate in a **highly cost-competitive** environment. Many already have the headroom within the cap to – theoretically – allocate to illiquids, however the marginal increase in cost would risk making them uncompetitive to corporates selecting a master trust for employees. Even with performance fees exempted from the cap, overall investment costs would increase nonetheless, and so allocations would likely remain very limited – this is true even for the largest of schemes.
- There are also well-documented operational barriers to DC schemes investing in illiquids in the shape of the **daily dealing** requirement of most investment platforms. We agree with paragraph 47 of the consultation that given the long-term nature of pension savings, the ability to trade and price daily shouldn't be necessary, and we would hope to see platforms increasingly facilitating this. However, we must not overlook their current capabilities and the time and resources required for them to update systems and processes to accommodate non-daily traded assets. Therefore, increasing allocations will inevitably be an incremental development.
- Another **liquidity** barrier is the concern among schemes in relation to **gating funds** at times of high redemptions, something which has borne material cost for certain employers. If trustees had assurance from tPR that it was reasonable to gate funds and for members to wait for redemptions – without claims against the scheme – they might have more confidence in allocating to illiquids. Similarly, trustees would welcome tPR guidance on the fair treatment of members regarding infrequently priced funds and the potential for gains/losses due to value fluctuations between pricing points.
- Finally, despite the FCA's removal of the 35% cap on unit-linked funds' investment in illiquids, few schemes have increased allocations due to other barriers, including complex tax and structuring issues associated with accessing illiquid assets through authorised vehicles (including the new Long Term Asset Fund).

### *Availability of non-performance fee charging*

An increasing number of large schemes are making allocations to illiquids – but without performance fees. The bargaining power and scale to negotiate new charging structures is only within reach of a small number of schemes, but momentum is in this direction, and as more of the market consolidates, and as DC assets grow further, the prize for fund managers willing to reduce and innovate their charging structures will grow. Therefore, we would urge some patience as the market develops – tPR expects DC assets to overtake DB in the next 15 years[2] - and caution against attempting to artificially accelerate this process at the possible expense of member protection. The

[1] https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2020-2021
[2] https://www.thepensionsregulator.gov.uk/en/document-library/corporate-information/corporate-plans/tpr-strategy-pensions-of-the-future#7218018e044642f08287257b7e0f5bcb

accommodation of performance fees may in fact be counter-productive in terms of the fee innovation as it creates less incentive for managers to compete through innovation of charging practices in the short term, despite some already having done so.

***Disclose & explain requirements***

With all this in mind, we consider the fiduciary duty borne by trustees as more important than ever as they continue to take responsibility for the long-term financial health of their members. On this basis we view the ‘disclose and explain’ requirement as preferable to any more prescriptive requirement considered (e.g. ‘comply or explain’, as per paragraph 13), which might compel trustees to invest in a certain way, which would represent a fundamental undermining of trustees’ fiduciary duty and compromise their ability to act in their members’ best financial interests when investing scheme assets. The member demographics of different schemes are hugely diverse, and their needs similarly wide-ranging so it is unlikely anyone other than a scheme’s trustees will have the necessary knowledge to make investment decisions tailored to a particular membership and we think it is paramount that trustees retain primacy over investment decisions. We note also that trustees are already required to disclose in the SIP their policies in relation to the “kind of investments” held and exercise their investment duties to ensure scheme assets are properly diversified, so it remains unclear what the new disclose and explain policy materially adds to this.

***Disclosure format***

In terms of the reporting and disclosures proposed in the draft regulations, the approach in the draft guidance will be helpful for some schemes, while schemes will welcome the flexibility in terms of format. We do, however, think it would be reassuring to schemes if some more emphasis were placed on the optional nature of asset allocation averaging. Regarding disclosure ‘products’, we agree that the Default SIP would be the most appropriate location for trustees’ illiquid policies (for relevant DC schemes), but question whether the Chair’s Statement is the correct place for the net returns disclosures. The Chair’s Statement covers governance, administration and Value For Money (VFM) (as per the Scheme Administration Regulations 1996), while the SIP covers investment (as per the Investment Regulations 2005), so we see this conflation of the two documents leading to duplication of disclosure. Timing of new disclosures should also be aligned with the overhauled VFM and Chair’s Statement regimes in order to avoid wasted or duplicated effort and minimise the risk of further new products which are of mismatched or limited utility to their intended audience, as has been the case with the Chair’s Statement.

***In conclusion***

We remain committed to working with government on gradually increasing the exposure of DC schemes to assets with the genuine potential to garner greater returns, but do urge patience with –

and consideration of – existing initiatives to this end. For example, following work with the Productive Finance Working Group, the Long Term Asset Fund structure is now in place, but to date no funds are up and running. These initiatives take time, and we would suggest evaluation of existing projects on the already evolving market before any further requirements are imposed on trustees.

Yours sincerely

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