Pensions review: call for evidence

PLSA response

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?**

    1. Larger pension schemes can facilitate better outcomes for pension savers. Larger schemes generally benefit from economies of scale, stronger governance, the ability to negotiate more favourable costs and charges, and the resources to provide a full suite of member services. In particular, consolidated pension funds can invest more in asset classes requiring high governance costs such as unlisted equity and infrastructure. Consolidation, where it is in the interests of members and represents value for money, is a positive ambition for the Government and the sector.

    2. Increasing saver contributions would have a much more significant impact on saver outcomes. It would also deliver scale in the DC market more quickly.

    3. The DC sector is already consolidating rapidly; we expect this to continue. Most DC savers and assets are served by around a dozen insurers offering Group Personal Pensions, and 36 authorised master trusts. The latter are expected to grow from AUM of around £130 billion in 2023 to about £420 billion by 2030. Three of the largest master trusts already manage at least £25 billion in assets. Some GPPs also operate at this scale. At the opposite extreme the number of DC schemes with more than 12 members has declined 67% since 2012; only schemes with over 5000 members have increased in number over that period.

    4. Based on PLSA member feedback, as AUM reach c.£20 billion schemes can start to co-invest in private markets; above this schemes can invest directly and may increasingly use in-house investment. Above c£100 billion benefits of scale increase more slowly.

    5. Data from CEM highlights that a typical £1 billion fund invests 11% in private markets; a £20 billion fund invests 20%; and a £100 billion fund invests 23%.

    6. The benefits of scale can be delivered in different ways, for example through consolidated investment platforms, particularly relevant for DC pensions. Illiquid assets can be made accessible via the asset management industry e.g. LTAFs, or by Government-initiated entities such as the BBB.

    7. The risks of consolidation include lack of competition; higher entry barriers for new entrants or disrupters; herding of investment choice; potential systemic risk; liquidity risk; loss of bespoke benefits negotiated between employers and members; and the closure of good small pension schemes. Above a certain scale it becomes uneconomic for large schemes to make smaller investments – which

can hinder capital flows to local projects. There is also some concern that the 'rating' methodology in the FCA VFM framework will increase homogeneity preventing schemes taking on new business or forcing them to exit the market.

8. Some providers restrict the size of employer they will take as a client for commercial reasons. A consolidated market would need to retain a reasonable array of choice for SME employers, and features such as at-retirement guidance and decumulation solutions.

9. A more consolidated DC market may be positive for economic growth. There is not however a direct causation between scale and UK investing. This will depend on fiscal, regulatory and other factors.

New question: What are the likely impacts of a higher concentration of savers and assets in schemes or providers with scale?

1. Consolidated pension funds can invest more in asset classes requiring high governance costs such as unlisted equity and infrastructure. Based on PLSA member feedback, as AUM reach c.£20 billion schemes can start to co-invest in private markets; above this schemes can invest directly and may increasingly use in-house investment. Above c£100 billion benefits of scale increase more slowly.

2. Above a certain scale it becomes uneconomic for large schemes to make smaller investments – which can hinder capital flows to local projects.

3. Some providers restrict the size of employer they will take as a client for commercial reasons. A consolidated market would need to retain a reasonable array of choice for SME employers, and features such as at-retirement guidance and decumulation solutions.

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

1. Single Employer Trusts vary enormously in size and quality, from a small number of large schemes with superior governance and a high allocation to alternative assets, to many small (£100m), less well-run which do not normally invest in assets other than pooled funds. Well over 90% of DC schemes are very small, typically executive pension plans catering for less than 12 members each, and have very low levels of assets

2. These smaller schemes are already subject to value for money tests. We would observe that regulators have not to date carried out much enforcement activity, or exercised their powers to wind-up underperforming schemes.

3. We believe single employer trusts should be available for employers who want to offer them – some employers will continue to want specific provision or services (though for others this will not be a priority). We see no reason to restrict this choice, provided the scheme is of high quality. Many will be of significant scale. This is also the case in other jurisdictions such as Australia.

4. There is evidence that employees trust their employer to look after their pension provision, and to provide support. This is an important factor for helping savers achieve good outcomes, especially when FCA evidence suggests that the vast

majority of savers have poor financial literacy, and generally mistrust, or are confused by, the investment and advice markets.

5. Employees and unions may feel they retain more ownership if they have an "own" trust model – particularly if they have had a DB scheme in the past. Services from master trusts may not always be tailored to individual employee groups and sometimes may seem distant or remote to employees.

6. Single or multi-employer trusts that are not competing on a commercial basis are currently generally able to offer more sophisticated (and less price constrained) default strategies, encompassing a wider range of asset classes, where this is in the interest of their specific membership. Single employer trusts may not be small scale throughout their value chain for example using a consolidated investment platform.

7. Significant consolidation has already taken place in DC pensions. The number of DC schemes with more than 12 members has declined 67% since 2012; at the same time the number with 5000+ members has increased. The majority of own trusts that have closed have transferred their savers to master trusts. We expect this trend to continue. Further consolidation of the next tier of small schemes, between 12 and 99 members, will moreover make relatively little difference to the objective of increasing the range of investments via consolidation. The assets of occupational DC schemes with 12-99 members represents just 0.23% of total DC assets.

8. Following the introduction of the Master Trust authorisation regime we already have many fewer master trusts, and relative market concentration, by volume of providers, as compared with other, similar markets (e.g. Australia).

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?

1. The extent of investment in diversified assets, including UK productive assets, is likely to be driven by scale in particular, the pipeline of opportunities, and suitable product structures rather than the legal form, whether trust or contract-based, of a scheme.

2. Investment strategies are similar between the two structures of master trusts and GPPs in many providers: with both propositions the underlying investments are identical (at a default fund level).

3. Trustees are subject to the fiduciary duty; independent governance committees of contract-based schemes have similar, but not identical, requirements; moreover, the recent introduction of the "consumer duty" in contract-based schemes means that they are increasingly regulated in a manner similar to trust-based schemes. In any case, the impact on investment choice as a result of governance structure is negligible.

4. Trust-based schemes are scalable and have the freedom to regularly change investment strategy where this is in the best interest of members. Scale economies also exist at the fund level. The contract-based schemes run by the large providers also have scale.

5. The DC landscape is expected to change significantly over the next decade. Trust based schemes are expected to continue to increase their overall share of the DC market given the rapid growth in membership and AUM of master trusts.

6. We expect contract-based scheme provision to continue to remain a significant proportion of the market and to grow, in particular among the largest providers.

7. The role of retail consolidators – and more generally non-workplace pensions - should also be considered given they are out of scope of the VFM requirements, typically have high charges for savers, and are more unlikely to access 'new' investment strategies due to a lack of scale.

8. We believe the Government should clearly define 'UK productive assets' to ensure there is a consistent measure of investment by UK pension funds. This will provide a true picture of whether schemes are over or underweight compared with reasonable targeted (default) investment strategies.

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

1. The DC sector has consolidated rapidly over the last five years, and we expect this trend to continue. Most DC assets are already managed by around a dozen insurers offering Group Personal Pensions and 36 authorised master trusts. Three of the largest master trusts already manage £25 billion or more in assets each and a number of schemes have the operational aim to achieve scale of £100 billion by 2030. A number of the large insurers providing Group Personal Pensions are already operating at this scale.

2. Barriers to consolidation include: commercial viability (to receiving schemes), capacity within the market, transition issues (data, investments), benefit design and complexity (i.e. absorbing schemes with guarantees), regulatory issues (breaking agreed terms and conditions within contracts, transferring between contract and trust based regimes), the volume of other change initiatives (e.g. dashboards).

3. There are a number of regulatory constraints that prevent the consolidation of contract-based schemes - to switch savers from legacy contracts, new defaults or between contract and trust-based provision. For example, contract-based schemes require individual member consent, which presents enormous practical hurdles, to making changes. Government and regulators should review these barriers to simplify these obligations, whilst retaining appropriate member protections. We would be happy to provide industry input to identify key issues and the solutions.

4. In the case of trusts, while individual consent is not an obstacle, other regulatory issues, such as the treatment of guaranteed minimum pensions or being able easily to use DB surplus for the benefit of DC members, can slow down or prevent change.

5. The Government should consider recent merger and acquisition activity in the master trust and life market as case examples for learning from the experience of barriers and challenges to consolidation.

5. To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?

1. With assets totalling more than £425bn, the Local Government Pension Scheme is one of the largest pension schemes in the world. Harnessing that scale has the potential to enable the LGPS to play a key role in supporting investment in the UK while meeting its fiduciary responsibility.

2. The introduction of asset pooling was a significant change in the structure of the LGPS. It has mostly been delivered successfully in line with the original policy – to create asset pools of c£25 billion and deliver investment cost savings. Since pooling was introduced the Government has also asked, across different periods, the LGPS to invest in a range of different asset classes (e.g. infrastructure, levelling up, and private markets) which it has responded to.

3. To date, 39% of assets have been transferred, a further 31% of assets are under pool management, and annual cost savings of £180 million have been delivered. Overall, the LGPS is now very well-funded and members' benefits are secure.

4. As an open DB scheme, the LGPS has the long-term investment horizon to invest in illiquid assets such as private markets. Alternative investments represented 17% of total allocation in 2023 compared with 11% in 2018. Pooling has also helped to reduce costs significantly (by c 30% vs typical institutional investor private market costs).

5. There have been beneficial collaborations between pools. For example GLIL (a collaboration between the Northern LGPS and LPP pools) has allowed funds to obtain the scale to obtain stakes and governance rights in direct infrastructure assets that they would not otherwise have been able to do.

6. Local authority funds have delivered positive real investment returns and increased investments in alternatives. Regarding investment returns, over the medium term the average fund has delivered a return of around 7% per annum, a real return of 2% pa over 5 years, and a 4.5% return over 10 years. In relation to alternatives funds have reallocated 12% of total assets from equities into alternatives over the last decade, with a marked increase since pooling was introduced.

7. We support the continued development of the LGPS pool model. More critical to success than a particular design of the pooling model is clarity of roles and responsibilities of funds and pools. We support MHCLG's commitment to providing its long-awaited guidance in this area.

8. Completing the transfer of remaining assets to pools is important. However, this needs to be done in a pragmatic way that is not destructive of value or incurs unnecessary investment losses or costs. As such we do not support the introduction of unachievable short-term deadlines for the completion of asset transfers.

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?

1. It is important to recognise that schemes are typically charging below the charge cap for a variety of reasons. In theory this headroom could be utilised to invest in illiquid or other alternative assets which typically carry a higher management fee.

2. However, there is a structural issue that in a consolidating and competitive market, the focus of employers and savers is on lower fees for provision of services. The result is a market 'price point' at the levels currently seen. As a result, incorporating significant amounts of illiquids into mainstream commercial DC defaults, whose investment budget may range from less than 5bps to 15bps, is unachievable. Higher charges will be uncompetitive and therefore would not be commercially viable. For example, we understand that having a 5% allocation to venture capital in a default fund could effectively double the total cost of the investment portfolio.

3. There is no 'silver bullet' to alter the structure of the market. However, changing employer behaviours and choices is central to altering the current market dynamic, and this aspect has largely been overlooked by more recent policy interventions.

4. Employers choose schemes if they don't choose to run their own, and corporate IFAs and EBCs help them to pick a provider. This process and the role of advisors in it is currently unregulated, other than the guidance to employers that they must choose a default fund that is suitable for member needs. Recommendations from the CMA, which we support, to regulate this part of the value chain have not been progressed.

5. This selection process might lead employers to either a master trust or a GPP depending on various factors. Employers generally select providers on the basis of: cost, investment choice and fund ranges (e.g. through an investment platform), and ease of administration and service. Current TPR guidance to employers is oriented towards cost rather than value for money. Changes to this guidance to focus more on value for money and member outcomes would be welcome.

6. EBCs and investment consultants provide expertise and support to decision makers when needed, on a one-off or ongoing basis. They are not incentivised to focus unduly on cost, though they will cater information to their clients' needs and priorities. Corporate IFAs might get paid by cross selling and some schemes are much more reliant on advisory services than others.

7. The costs of asset management (and therefore investment costs, especially for default-suitable investment strategies) have generally been decreasing due to the influx of cheaper tracker funds – which have offered good returns for savers.

8. Increasing focus on price has led to unhealthy competition to reduce costs rather than increasing performance including service level performance. All providers

offer differential pricing (other than NEST, due to its requirement to provide a universal offering).

9. Fiduciary duty requires trustees to consider all factors relevant to member outcomes; this is not just cost but net return from any investment opportunities (and so potential returns will need to outweigh the cost).

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?

1. The PLSA has made 12 recommendations for intervention which will lead to higher investment, and in a wider range of assets. These are:

2. All schemes:

    - Establish a pipeline of investable assets. The PLSA has provided practical examples of sectors where pension funds could invest to increase UK growth; and what steps are needed by Government and the pension industry to achieve this. These measures are set out in our report, Pensions and Growth: Creating a Pipeline of Investable UK Opportunities.

    - Provide fiscal and investment incentives: measures include providing an incentive, as is common in many other countries, for pension funds to invest in UK companies compared with non-UK.

    - Policy certainty: setting out a clear plan for the future of the UK economy, e.g. by setting out an industrial strategy for key tasks like the green transition. Addressing long-standing barriers to growth, including reforming the UK's planning system, are also needed.

3. Defined contribution schemes

    - Incentivise the market so that employers and others purchasing workplace pensions balance net performance and costs in focusing on member outcomes. This involves amending the employer duty related to default funds and introducing a value for money regime.

    - Consider regulating the advice of investment consultants, and ensuring advice from regulated IFAs addresses the impact on scheme members.

    - Consolidate investments as well as schemes e.g. using fund of fund investment vehicles.

4. LGPS

    - Implement the LGPS Scheme Advisory Board's Good Governance Review

    - Focus on making the current fund and pool structures work well. In addition, make appropriate transfer of assets from pension funds to the pools where this is in the interest of scheme members.

- Increase resources devoted to the operation of the LGPS.

5. Defined benefit schemes

   - More regulatory flexibility for open DB schemes given their greater ability to carry long term risks.

   - Ensure the Solvency UK regime enables insurers to hold more illiquid assets so these can be accepted from pension funds as part of a buy out transaction.

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?**

   1. Allocation by pension funds to UK investments must be part of a package of measures by different parties. The importance of a clear national strategy, a consistent regulatory framework and policies that support the creation of investible opportunities cannot be overstated in securing investor confidence and willingness to invest in long-term projects. The role of fiscal incentives, to generate momentum for change over the short-term or long-term will also be an important lever at the Government's disposal. Initiatives such as LIFTs or the proposed public/ private financing of projects through the NWF are additional measures.

   2. Larger pension funds are likely to invest more in asset classes requiring high governance costs such as unlisted equity and infrastructure. It does not automatically follow that investment in those asset classes will be in the UK, unless the UK opportunities are either competitive or fiscally advantageous. To the extent it does it is likely to be beneficial for UK growth.

   3. Investment in domestic equity markets has fallen in all of the major pension countries from 67.1% in 2002 to 37.7% in 2022. The domestic allocation in the UK is above the average of the other countries in the sample (Australia, Canada, Japan, Netherlands, Switzerland, US).

   4. The UK's historically weak economic performance over recent decades, as well as political uncertainty, has also played a significant role in its attractiveness as a place to invest. For example, the average annual growth from 1998 to 2023 for the FTSE all share was 5.15%, whereas the MSCI World was 7.73%. An original 1998 investment of £1bn would be £3.5bn (FTSE) vs £6.4bn (MSCI).

   5. Pension funds allocate to assets that will deliver the best/most appropriate return for their members. In the UK and elsewhere they have since the financial crisis increased significantly investments in asset classes such as unlisted equity and infrastructure in a search for yield. Further consolidation would increase the capacity of pension schemes to access and manage such assets.

6. LGPS funds and pools have traditionally invested in UK assets including local investments. Feedback from pension fund and asset fund members has repeatedly shown that lack of investment lies more with the availability of assets which are fit for purpose and less with funds being available to make these investments. There are a number of important steps that Government can take to develop a pipeline of opportunities.

7. Indeed particularly given this context, in the absence of Government adopting the steps proposed by the PLSA to make UK investment more attractive, consolidation is likely to lead to greater investment in illiquid assets but not necessarily to increased UK investment. For example, consolidation may make it easier for pension funds to access US private markets whose characteristics may be more aligned to pension fund needs.

2. 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?

1. It is important to recognise that the UK pensions market is not homogenous. The factors impacting the DB market, open/closed schemes, funded public sector and the relatively immature post auto-enrolment DC market are very different. We set out below some of the key factors across the sector:

2. The closure of most private sector defined benefit schemes. Their members require, or will require, predictable incomes in retirement, That in turn incentivises these schemes to reduce their allocation to equities and increase allocation to bonds. This has provided the UK with a deep and stable gilt market which supports Government expenditure. Changes in regulatory, actuarial and accounting requirements in relation to defined benefit schemes have also encouraged employers and schemes to derisk.

3. A thriving but consolidating DC market. This has led to competition based on price rather than performance in DC. This does not incentivise longer term or riskier private market investment. In addition, the DC market is relatively immature. The larger proportion of pension scheme assets are still in defined benefit schemes. Increasing contributions would help address this. Automatic enrolment contributions, at 8% of band earnings, are too low and need to gradually increase to 12% of salary.

4. Poor returns in the UK market. The average annual growth from 1998 to 2023 for the FTSE all share was 5.15%, whereas the MSCI World was 7.73%. An original 1998 investment of £1bn would be £3.5bn (FTSE) vs £6.4bn (MSCI). Lower return is particularly detrimental for DC members who bear all the investment risk. Other factors relating to poor returns include the concentration of the UK stock market in the oil, mining and banking sectors.

3. 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?

1. The importance of a clear national strategy, a consistent regulatory framework and policies that support the creation of investible opportunities cannot be overstated.

2. We welcome the Government's focus on delivering this and supporting initiatives including the NWF and LIFTs.

3. The PLSA supports the use of appropriate incentives aimed at increasing UK investment by pension schemes:

    - Make greater use of blended finance.
        - Expand the already successful LIFTS initiative.
        - Government commitments on large-scale infrastructure projects could include guarantees.
    - Fiscal incentives
        - Net zero incentives such as for electric vehicles and charging points.
        - Fiscal incentives to target specific UK sectors, projects or places in need of investment.
        - Other measures such as levy discounts and reinstating the dividend tax credit.
    - Investment vehicles:
        - The capital behind the NWF and BBB could act as a government-backed provider of liquidity.
        - Co-investment vehicles with British Patient Capital.
        - Tax credits for investment vehicles.
    - Regulatory reforms:
        - DC:
            - Introducing a Value for Money regime for both trust-based and contract-based DC schemes and a revised duty on employers to choose a high performing scheme for their workforce.
            - Regulation of investment consultants and IFAs when serving the corporate market so they are required to recommend to employers schemes which offer value for money rather than low cost schemes.
        - LGPS:
            - Implementation of the recommendations of the Good Governance review

- Orderly <u>transition of assets</u> to pools

4. The PLSA strongly supports continuation of fiduciary duty. UK pension funds of all types already invest in a wide range of asset classes. Investing in a diverse portfolio of assets is recognised as best practice within the industry, and by UK regulatory bodies and guidance.

5. PLSA would not support Government intervention to direct investment to a particular jurisdiction or asset classes. Mandation would risk distorting effects as capital is driven into markets that are not ready to receive it and is withdrawn from other asset classes incurring potential loss of value and administrative costs.

6. If the Government does seek to encourage local investment, we strongly recommend a definition that stresses investment in physical, social or intellectual capital in the UK, achieving the required investment returns for an appropriate level of risk. Any requirement in relation to private markets should encompass the whole range of private asset classes and across the capital structure, including real estate, private credit and infrastructure.

7. The charge cap does not have any relevant impact on how the market operates currently and it is not constraining investment budgets. PLSA survey data indicates fees are an average of about 0.4%, Investment in illiquid assets is difficult at this level of fees. We urge consideration of this and other barriers to greater investment in illiquid assets.

8. The supply of funds for DC investments would be raised by increasing pension contributions to better provide adequate pensions in retirement. This would help offset the maturing of the DB market and provide a deep pool of UK institutional capital.