ASSOCIATION OF CONSULTING ACTUARIES

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10 November 2022

To: DC Policy, Investment and Governance Team, Department for Work and Pensions
pensions.investment@dwp.gov.uk

Dear All

Consultation: Broadening the investment opportunities of DC pension schemes

I am writing on behalf of the **Association of Consulting Actuaries** in response to the above call for evidence. Our answers to your specific questions are set out on the following pages.

We remain supportive of broadening the investment opportunities for DC schemes, and broadly speaking we believe the draft regulations and guidance meet the policy intent. From a practical perspective, we see no issues (other than trustee time and cost) with schemes meeting the additional requirements for the disclosures.

However, fundamental challenges remain with making allocations to illiquid assets for DC schemes, which are not addressed by these regulation changes. Our concern is that the regulations will only serve to increase the disclosures that are required by trustees, increasing their governance burden at arguably no benefit to members, and without having any material impact on allocations to private market investments / illiquid assets.

As noted in our previous engagement with the DWP, we do not believe that the inclusion of performance-based fees within the charge cap has been a barrier to implementation of certain asset classes to date. Excluding performance fees from the charge cap is seen by many as "fudge" and in our view represents a reduction in the protection offered to members of occupational pension schemes and could lead to "fee arbitrage" (a scenario where asset managers look to change their fee structures, lowering their fixed fee and introducing a performance-based fee, to "benefit" from the charge cap exemption). This could result in a member paying significantly more for the same gross of fees return whilst still being within the charge cap. Finally, we question how performance-based fees can be applied fairly to each member, or even broad cohorts of members.

We would be happy to discuss our response further if that is helpful. In that event, please contact me on 07557 031198 or at tessa.page@mercer.com.

Yours sincerely

Tess Page, Chair, DC Committee
On behalf of the Association of Consulting Actuaries Limited

ACA response to the consultation on broadening the investment opportunities of defined contribution pension schemes

1. Do you have any comments on the draft regulations in relation to the disclose and explain provisions? Please include in your answer any comments on whether you consider they meet the stated policy intent.

We believe the draft regulations meet the policy intent.

In particular, we strongly support the approach taken of seeking to balance prescription / standardisation with pragmatism (keeping the requirements high level enough that pension scheme trustees are not over-burdened by compliance-heavy disclosures, retaining the ability to prepare their disclosures in line with their investment strategy design).

Broadly speaking, this view also applies to the definition to be used for "illiquid assets" which we believe captures the breadth of these investments without descending into technicalities. However, so as to avoid assets that are not deemed illiquid under normal market conditions falling into scope and / or requiring more onerous reporting and commentary, it may be helpful to clarify that the characteristics under the proposed definition are "ongoing" characteristics or similar (i.e. a permanent feature of the asset class). An example here is the gilt and credit market volatility observed in September / October 2022.

We also believe that clarity is required in respect of whether the requirements apply to relevant schemes, with 100 or more members. Our understanding is that the intent is for these schemes **not** to be in scope (e.g. the Consultation response states "**Impact on small schemes** – The scope of the proposed amendments of the SIP and chair's statement regulations is consistent with existing SIP and chair's statement rules i.e., relevant occupational DC pension schemes with 100 or more members. Therefore, we do not expect small pension schemes will be excessively impacted by these proposals"). However, the draft regulations , as confirmed by paragraphs 96 and 97 of the consultation response, provides for the policy on illiquids to be included in the default SIP rather than the whole scheme SIP. Default SIPs, unlike whole scheme SIPs, are required to be produced by schemes with less than 100 members. Similarly, the Chair's Statement applies to all "relevant" schemes (again, no 100 member floor). The draft Regulations and Guidance do not contain an exclusion for schemes with under 100 members. If the policy intent is to exclude relevant schemes with under 100 members from the new requirements, the draft Regulations and Guidance will need to be amended accordingly.

We further note that it appears that all default arrangements would be impacted by the regulations, which can be a large number, including funds that may have a very low level of assets invested in them (e.g. for technical defaults that legacy funds have been mapped to). Given the intent of the regulations, we believe that it would be appropriate to require only that "popular arrangements" should be covered, using the same definition as in the Climate Change Regulations.

We consider it sensible that the changes intended to facilitate and monitor investment in illiquid assets in DC schemes are also considered for CMP schemes. We believe that this position is appropriately reflected in the draft regulations and statutory guidance. That said, we have noted in the past that there is a strong case for CMP schemes to be subjected to a higher charge cap than applies to DC schemes. This is because there is significantly greater scope for CMP schemes to invest in illiquid assets (and other longer-term investments that might attract higher charges but where the impact of this is expected to be more than offset by significantly higher returns).

2. Are there other elements not covered in these regulations that you would expect to see?

No.

In general, we remain concerned about the way that the content required to meet the disclosure requirements for Chair's Statements and SIPs has grown over time. For schemes also preparing implementation statements and TCFD reports, along with an annual investment report and SORP risk disclosures for the scheme accounts, there is considerable scope for duplication and member confusion. We strongly support transparency but it would be a valuable exercise to undertake a further review of the various documents, with simplification in mind. We recognise that the DWP has acknowledged this issue for Chair statements (including the establishment of the Chair Statement Working Party) but we believe there is a need to consider the reporting requirements in the round, relative to the (additional) requirements of the Own Risk Assessment, to avoid duplication.

3. A. Do you have any comments on the proposed regulatory asset allocation disclosure requirements included in the draft statutory guidance?

We believe that the draft guidance and asset class breakdown template captures the range of asset classes that a DC pension scheme will typically use.

It is helpful that the guidance confirms that multi-asset funds (such as diversified growth funds, used by many DC schemes) should be considered on a "look through" basis. We do note some potential challenges to preparing the disclosures, particularly in respect of multi-asset funds:
- Different multi-asset managers will typically provide asset allocation information in different formats using different asset class categories.
- Some multi-asset managers do not provide asset allocation information on a "physical" basis, but instead based on risk exposures.
- The proposals expect trustees to comment on their policy regarding illiquid holdings within other multi-asset and diversified funds (e.g. DGFs). We expect that Trustees are not likely to look through to specific illiquid holdings within a DGF when selecting a fund manager. Rather, these should be viewed as part of the DGF manager's policies with regards to how they achieve their objectives.
- There is the potential for mis-reporting where listed private equity, listed infrastructure, and listed real estate assets are held (i.e. these could be classified by some managers as private markets when in fact they are listed equivalents).

However, whilst these issues can complicate data gathering and reporting, we do not consider them to be insurmountable to overcome. A template for manager data requests would assist with this.

We remain unconvinced by the statement that "The disclosure of schemes' policies on illiquid investments and their asset allocations will improve the availability of investment information to members and employers and provide them with the certainty that schemes are providing members with the <u>best possible value</u>" (our emphasis). In particular, we expect that whether or not an investment strategy provides the "best possible value" will not be able to be obtained from the new disclosures intended for the SIP or the Chair's statement; instead this is expected to come from the value for members assessment and the current work that the FCA and TPR are undertaking to design standardised metrics to enable comparisons between schemes.

3 B. Are there any areas where further clarity might be required?

Derivative exposures will be challenging to report on, but we believe this has been addressed well in the guidance.

4. Do you agree with the information presented in the impact assessment?

We consider the assessment to be optimistic on the likely costs of implementing these changes. Typically, DC schemes with over 100 members have more than just the three trustees assumed in the analysis, and we expect it will take most trustees more than the assumed 1.6 hours to become familiar with the new material.

In isolation we could get comfortable with the analysis, but the "layering" of disclosure obligations across multiple documents adds to the time and cost of professional advice required. It is not unusual for a trustee board to request input from their investment consultant, governance consultant, legal adviser, and auditor, along with reviews from the trustee board itself and the employer. Across the Chair's Statement, SIP, accounting disclosures, implementation report, and for some schemes the TCFD report, the cost and time required for document preparation multiplies as documents must be reviewed for consistency.

5. Do you have any comments on the impact of our 'disclose and explain' proposals on protected groups and how any negative effects may be mitigated?

It would be valuable to include in the guidance specific examples of requirements for schemes that are winding up / moving to a new scheme design (e.g. master trust). Our experience is that there is a nervousness from these schemes on falling foul of the disclosure requirements, so lengthy and expensive statements are produced when they are no longer of value or relevance to members.

6. Do you have any comments on the draft regulations in relation to the performance fee measures? Please include in your answer any comments on whether you consider they meet the stated policy intent.

The consultation document (paragraph 116) and draft Guidance (paragraph 37) refer to an "option" to exclude "specified performance-related fees" from the charge cap. However, our understanding is that under the draft Regulations "specified performance-related fees" still need to be identified and disclosed within the Chair's Statement, regardless of whether they have been excluded from calculations for the purposes of the charge cap. We agree that this is appropriate but it would be helpful to state this more explicitly in the Guidance, for the avoidance of doubt.

We highlight that a number of practical challenges remain in relation to implementing performance-related fee structures. It is encouraging to see a small number of investment managers working on solutions in this respect, but fairness by cohort / tenure of members remains a challenge. This will not be overcome by the new regulations or the removal of performance fees from the charge cap.

7. Are there other elements not covered in these regulations that you would expect to see?

No.

8. A. Do you have any comments on the performance fee sections of the draft statutory guidance? B. Are there any areas where further clarity might be required?

The guidance provides useful definitions and examples. In a similar vein to our comments under question 6 though, we consider that the J-curve example and the statement “Trustees should work with fund managers and other professionals to ensure that the spread of cost/benefit is fair for all scheme members” will not assist trustees on a practical level with understanding how such fairness could be achieved. For many boards, even the best-governed, member fairness will remain a barrier.

9. Do you have any comments on the impact of our proposals, in relation to the exemption of performance-based fees on protected groups and how any negative effects may be mitigated?

No further comments.

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