ASSOCIATION OF CONSULTING ACTUARIES

EVIDENCE FROM

THE ASSOCIATION OF CONSULTING ACTUARIES TO PENSIONS INVESTMENT REVIEW

Government call for evidence by 25 September 2024

Call for evidence questions: 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?

It can be argued, the current disaggregated model for pensions in the UK, with numerous schemes, providers and different regulators across different arrangements creates inefficiencies. A market that avoids duplication and builds scale should result in a benefit to members and the economy, and several initiatives already in progress will help. It is vital that further reforms are undertaken in a joined-up manner, with a clear end goal that fosters confidence and stability.

Advantages to savers

- Scale bringing access to wider range of investments and ability to manage illiquidity better.
- Potential for asset managers or solution providers to be awarded larger mandates should spur product innovation in the accumulation and decumulation market.
- Scale to deliver decumulation options with the ability to offer security, flexibility with potential better outcomes for individuals.
- Economies of scale leading to better VFM.
- Greater potential to operate whole-life and decumulation-only Collective Defined Contribution (CDC) arrangements with ~~the~~ benefits of risk sharing and investment flexibility.
- Stronger governance with more professionalism of governance bodies.
- Individual pots (and small pots) consolidated in fewer places. Individuals can model all their pensions in one place and make better decisions on saving levels, investments and retirement planning.
- Investment into the technology and proposition to provide individualised communications and guidance/advice.

Risks to savers

- Decreased competition leading less choice and providers mimicking each other's proposition.
- Less innovation.
- A significant barrier to entry for new entrants.
- Doesn't solve adequacy issues for individuals and therefore continued reliance on State and/or potential workforce management issues.

- Unlike own trusts, the remaining commercial providers are operating for profit albeit with member focus through MT oversight and IGCs.
- Potential for informal collusion between providers on price.
- Reliance on defaults from a small number of solution providers (there would need to be safeguards against vertical integration with providers' asset managers).
- Consolidated views/less diversity on key beliefs (ESG, investment design principles) in the default.
- Provider risk (e.g. due to failure or cyber targeting) - i.e. providers become too big to fail.

Advantages to UK economic growth

- Assets could be mobilised to fund capital investment that builds the economy's productive capacity (public and private markets). The experience of mature markets, such as Australia, shows how DC funds can be a source of patient capital.
- Freeing up resource and time of multiple lay trustee boards and employer support for own trusts could allow focus on other key areas such as engagement and education.
- Impact on employment market to service members via personalised support or to manage the technology solutions.
- Increased engagement from savers if they can see tangible investments which could lead to more money being invested and improve adequacy.

Risks to UK economic growth

- Less trust in the more concentrated market, especially if herding is observed.
- Doesn't solve adequacy issues and therefore continued reliance on state benefits and/or potential workforce management issues.
- Additional regulatory oversight slows down investment.
- Risk of an 'artificial bubble' as schemes seek to invest in the finite number of opportunities available leading to poor performance.

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

Large Single Employer Trusts

- Those remaining Single Employer Trusts should be able to demonstrate that they are providing value (under the new VFM framework) vs those provided by large consolidation options.
- They retain control of their approach to investment design and have the opportunity to operate differently to a largely off the shelf market in a consolidated future DC market (albeit this can often be achieved through a bespoke Master Trust section). This has allowed a smaller number of own trusts to develop innovative investment solutions and member engagement programmes without the constraints that commercial propositions bring that are felt to better suit the needs of the employer's workforce.
- They should operate with flexibility to tailor to very specific beliefs of the trustees, employer and/or members and the industry that they operate in.

- Some of the largest single trust schemes have assets larger than Master Trusts and they drive innovation, so they would be a good counterbalance to effectively challenge the thinking of the consolidated future DC market.
- They should have a close relationship with the regulators to collaborate and provide information on a two-way basis, to allow input into future regulation and continued evidence of the value of the tailored approach.
- They should still disclose the rationale for remaining Single Employer Trust and provide strong evidence on how it is providing value to the membership but in a manner that is not cumbersome.
- An innovative, well-run scheme can be a tool to attract and retain talent and could enhance employer reputation and for multinational firms fit in with their international strategy, but the benefits would need to be effectively communicated to savers.

Single Employer Trusts with legacy benefits

- Single Employer Trusts, without any further intervention from the industry, may also be providing valuable legacy benefits to members that cannot be replaced in a consolidated future DC market (e.g. hybrids, DB underpins, top-ups, etc).
- There should be appropriate communications, support and guidance to those members to help them understand the advantages and disadvantages of remaining in the Single Employer Trust versus a consolidated future DC market.
- It is important that any consolidation strategy considers the features that may be lost on transfer and the appropriate mitigations should be embedded into the regulations.

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?

It is important to note that whilst there are significant new contribution flows to master trusts, the GPP assets are substantial and also continue to grow. Both types of arrangement should have a consistent regulatory framework to avoid arbitrage.

Comparison of roles and responsibilities of Master Trust Trustees and IGCs

- IGCs have oversight over higher asset levels, but largely the investment design of defaults is delivered to Master Trust and rolled across contract-based book as in many cases the composition of the Trustee Board and IGC has some overlap.
- IGCs currently have a high-level view and therefore are not seen to have teeth, when challenging the provider.
- Whilst IGCs are required by regulations, they can also act as a marketing tool to support new business (as do some Master Trust Trustees).

- Both IGC's and Master Trust Trustees should be wholly independent (including not sitting on more than one Master Trust) so there is no conflict and can be seen to influence and stand up for individual members.
- Trustees have a higher threshold for accepting a proposition change due to their fiduciary duty.
- IGCs have created change for legacy products and are now in a better position to look at the modern products. It has resulted in changes to the legacy product (or sale of closed books) rather than actual consolidation into modern products – this is partly due to legislation which makes bulk transfers from GPP's more difficult (e.g. where member/saver consent is required).

Considerations for adoption of new investment strategies that include exposure to UK productive assets

- Most likely to be providers with a long-term view and a view to provide a diversified approach to deliver risk managed returns to members at the right point in the saving lifetime
- Recognition that the allocation is disclosed as a % amount but the greater focus on savings and maximising contributions will result in a greater £ amount in UK productive assets
- Whether providers wish to increase price to offer this as well as significant cost of advice/research etc to achieve the balanced diversification or execution/implementation of advice
- If increased price, may result in lower cashflow to UK productive assets
- We don't want providers adding UK productive assets to tick a box to be competitive in new business, it needs to be articulated properly with a view of improving performance/overall value
- Expect that trustees and IGC are led by the provider in most circumstances

- 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?
- Potentially yes, depending on regulation to enforce/encourage this behaviour,
- Majority of the off-the-shelf defaults span both products,
- If the market follows Australia perfectly, we expect "not-for-profit" arrangements to become much more popular, and "for-profit" schemes to consolidate into those. In the long term this may happen if mass market players continue to grow.

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

- Legacy products or nuances e.g. underpins, Guaranteed Annuity Rates, protections and with-profits.
- Cost and timescales to undertake full process of consolidation. It is important that capacity constraints within the industry are considered and when undertaking consolidation, there is flexibility in the timings in line with the requirements of employers.

- Less incentive to consolidate at present – i.e. Low penalty for not consolidating even if evidencing poor value.
- Interactions with DB e.g. benefits of retaining DC for DB surplus – this could be addressed through legislative changes in relation to removing barriers for utilising surplus in DB schemes.
- Competition for time and budget with other significant pensions projects – dashboards, GMP equalisation, preparation for DB buy-out.

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?

There are measurable successes in LGPS pooling across all operating models, which includes:

- Lower management fees on listed assets. The majority of LGPS funds and pools report that pooling has provided for lower management fees in listed assets. This success can be attributed to a combination of scale, hard bargaining, and the willingness of asset managers to accept lower LGPS wide fees in the hope of winning more business from a smaller number of larger mandates.

- Access to alternative asset classes. Both fee structures and the ability to compete for opportunities have benefited from the scale and expertise available via pools which is demonstrated by an almost 50% rise in such assets since 2017.

- It is difficult to measure pooled returns against those which would have resulted from smaller mandates. However, the health of the LGPS in funding terms is a good indication that returns are at least meeting, or typically exceeding, the expectations of LGPS funds when setting their investment strategies and discount rates.

  The concept of "risk-adjusted returns" is not one defined across the LGPS. Responsibility for investment strategy, and therefore the level of risk, sits with funds, not pools. The level of risk a fund is willing to take depends on its employer base. Therefore, delivering "risk-adjusted returns" is achieved by both funds and the pools.

- Greater collaboration between LGPS funds within pools across areas other than investment. The bringing together of elected members and officers within pool governance structures has enabled and encouraged the sharing of best practice and ideas for improvement in communications, administration and systems.

The above successes are not always evidenced for the following reasons:

- The commitment to pooling as measured by assets going through the pool varies widely both across and within pools. Some pools are more successful than others with trust of the pool by the member LGPS funds being the main driver.

- On fees some funds continue to report that these would be no lower in the pool than they are able to achieve outside with the same manager. This could be a result of the LGPS fee structure referred to above and which some pools are more exposed to than others due to having multiple small mandates.

- The separation of strategic and implementation decisions is varied in its interpretation with some pools acting as near fiduciary managers and others more as platforms with significant levels of choice. This has resulted from a lack of clarity from government on what constitutes strategic decisions and the domain of LGPS funds on implementation.

- This lack of clarity will be particularly important when it comes to investment in UK asset classes. LGPS pools may be able to provide the level of investment the government is seeking, however whether this shift from global to UK assets could come without the express consent of the LGPS funds is questionable.

- The governance structures required to effectively manage pooling can be complex and time-consuming, drawing resources away from service delivery in other areas.

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?

Role and relative influence of employers on setting costs and impact on asset allocation

- An employer could step in to cover costs so not a factor for individuals' choice – however in practice many employers prefer for the costs to be borne by individuals.
- Influencing competition and pressure drive to the bottom on charges. Employers (via procurement teams) keen to flex their muscles on negotiation. Retaining and attracting staff based on the deal procured.
- Encouraging saving through contribution design, auto escalation and setting targets for retirement.
- By definition CDC schemes will be well-scaled and could offer greater value for money alongside the expected improved outcomes for savers.

Role and relative influence of advisers on setting costs and impact on asset allocation

- Education of value and benefits of other levers e.g. investment performance net of costs.
- Not assessing on a charge comparison basis.
- Can improve asset diversification.
- Focus on value over cost – and appreciating that this is not the most tangible measure but will lead to better outcomes.

Role and relative influence of trustees/IGC on setting costs and impact on asset allocation

- Communication of value and benefits of other levers e.g. investment performance net of costs.
- Driving and challenging advisors to focus on value.

Role and relative influence of pension providers on setting costs and impact on asset allocation

- Currently all control over setting costs in vertically integrated propositions.
- Important factor is payback period to launch scheme before they make ongoing profit / achieve financial sustainability.
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- Fear of spending and investing on innovation potentially leading to reduced asset diversification.
- Balanced with need to be innovative to drive new business and keep up with competitors.

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?

Yes, in a limited manner, though in some instances the issue is not cost but time and skills.

We note that there is a disproportional focus on costs in the ongoing governance of DC arrangements. In general, since the introduction of Auto Enrolment, low-cost DC offerings (typically with high allocations to cheaper passively managed equity funds) have performed strongly in absolute terms and relative to more expensive diversified approaches in the market. This backdrop makes it more challenging to make the case to expand the mix of underlying investments in each DC offering (i.e. certainty of fees increasing versus the expectation of delivering better long-term outcomes for members net of fees).

Overall, we advocate for:

- Intervention in the decision-making process for new master trust appointments. For any intervention to have a significant impact on relative importance of cost vs. value in master trust appointments, it would need to be targeted at employers and/or their advisers to require consideration of specified factors.
- Higher investment returns over the long term and greater understanding of short-term volatility should be encouraged.
- Members need to be educated and supported at all stages to understand the aims/objectives of investment.
- Wider range of asset classes and vehicle structures to allow for greater potential for innovation. As an example, LTAFs do not work for all schemes or platforms.

- Benchmarking investment performance could promote herding, and currently would make schemes with high UK allocations score poorly due to the performance of UK equities.
- Introduction of a price floor for investment design, could encourage a higher level of sophistication in a competitive environment but could lead to market distortion.

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?

Workplace DC

- Consolidation provides the ability for smaller schemes to be able to invest in asset classes (notably illiquid markets) which would otherwise be unattainable, due to the smaller size of the investment they would be able to make. In addition, non-listed asset classes require additional governance in terms of understanding (the asset classes are more complex to understand) and resources (such as with managing commitments and drawdowns in private markets). Consolidation can help reduce some of this additional burden on trustees.
- There needs to remain suitable diversification across consolidated pension provision to reduce systemic risks and concentration risks, as well as maintaining a level of competitiveness with costs and charges.
- The nature of, and longer-time horizons afforded by, whole-life CDC schemes naturally align with investing in productive assets.
- A more consolidated system needs to be insulated from future changes by way of a cross-party consensus.
- Independence of the decision-making and fiduciary duty needs to be considered. If investment in UK is desired, there may be a need to have incentivisation and/or safe harbour regulations.
- In addition, there need to be safeguards put in place to ensure the UK-based investments will improve UK growth rather than solely increasing corporate growth (and senior remuneration). Note that increased investment in UK equity on the secondary market does not automatically increase UK investment and growth, just the share price.

LGPS

There is an understandable view that consolidating into fewer, larger LGPS Funds and/or Pools may result in increased investment in UK assets. This outcome is not guaranteed:

- Investment strategies and risk appetites required to meet future LGPS liabilities may not change with scale without corresponding changes to governance structures and fiduciary duties.
- Consolidation requires significant time and resources to implement.

- Pools are already a significant size. If pools haven't already identified investable UK opportunities, would consolidation change that?

- Some LGPS funds already invest a significant proportion in UK assets and therefore already meeting this objective. Therefore, scale is not necessarily the key factor.

- Some innovative investments solutions for UK growth might be made harder by consolidation

- Are there the opportunities in the UK to enable the LGPS to benefit from increased scale?

For increased investment in UK assets, and avoiding potentially costly and time-delaying forced consolidations, could a mutually beneficial outcome be more swiftly achieved by exchanging:

- A commitment by the LGPS to invest a target amount in appropriate UK assets:

  for

- A commitment by government not to mandate changes to the scheme's structure for at least a parliament?

This would allow Government to understand if increased UK investment could be achieved without consolidation and the issues associated with it.

Cost

A focus on net return would recognise and provide for the increased costs related to unlisted investments and in that respect would be welcome to increase investment in these types of assets.

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?

- Many UK pension funds will set an investment strategy that is suitably diversified across a range of different risk factors to provide the required level of net investment returns. One of these factors will be geographical exposures.
- Over the last 10 – 20 years, the range of ways to invest has increased so investing globally has become materially easier and ease of access is a key to making any investment attractive.
- Many occupational DB pension schemes have a high exposure to the UK through allocations to government gilts.
- The funding position of many occupational DB pension schemes has improved since the mini-Budget in late 2022. This has driven many trustees to look to lock-in funding improvements and reduce the level of investment risk within the investment strategy. This has led to reductions in allocations to growth assets such as public equity, private market investments and real assets. Allocations to listed credit (such

as investment grade credit) will typically be global in nature though some schemes allocate solely to UK corporate bonds.

- Many private sector DB schemes have or are in the process of securing bulk annuities from insurers to cover the liabilities leading to further disinvestment from illiquid assets (including UK productive assets) and ultimately transfer to insurer asset books – this can be partially mitigated if proposed legislation change is brought forward to help encourage and incentivise DB schemes to run-on and deliver a sustainable surplus through investing in appropriate assets.
- DC pension schemes will offer exposure to equities through global funds, which invest in UK equities in line with the market capitalisation. Currently, this is less than 4%.
- For DC savers, investing in the UK does not guarantee improved saver outcomes. Placing a requirement to invest a certain amount in the UK may be detrimental to performance, relative to the broad global market.
- Incentives would help (e.g. as in Australia with tax break on domestic equities). Stamp duty on UK equities can be a disincentive.
- LGPS funds have capacity to invest in growth assets but will look for a globally diversified investment strategy. Many of these funds will allocate to UK-based investment opportunities as part of the previous government's Levelling Up agenda. This will typically be in real assets such as property or infrastructure.

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?

- The overall investment objectives of a pension scheme should drive the way in which a scheme invests. This includes return expectations, risk budget, liquidity budget and other considerations such as responsible investment requirements/preferences and any scheme specific objectives.
- UK investments need to come with better prospective returns. This means the focus should be on how to make UK PLC more attractive rather than driving investors to invest in UK PLC.
- For DC savers, investing in the UK does not guarantee improved saver outcomes. Placing a requirement to invest a certain amount in the UK may be detrimental to performance, relative to the broad global market. Incentivising investment in specific UK asset classes, for example government bonds, would change both the potential return and risk of that investment. This could potentially improve saver outcomes while boosting UK growth.

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LGPS Fiduciary duty

Before addressing incentives, the issue of fiduciary duty in the LGPS as a potential barrier to UK investment should be addressed. In the private sector the fiduciary duty of trustees is clearly set out. LGPS decision makers do not have a similar sense of clarity so asking the scheme to invest in UK growth opportunities without providing a level of reassurance around fiduciary duty risks missing the objective, as LGPS Funds fret about their responsibilities or genuinely feel they cannot, in good faith, target UK assets.

It would be helpful in such circumstances for Government to provide clear legislative backing and statutory guidance on how the LGPS can meet both the review's objectives and their fiduciary duty.

Incentives

Government could encourage LGPS investment in UK growth assets by:

- Providing tax incentives or other financial reliefs for investment in specific localities and/or industries
- Reviewing planning rules and increasing resources to support planning authorities
- Providing financial support for research and development in targeted sectors
- Working with the LGPS to identify and develop opportunities in UK growth assets
- Committing to a stable investment environment and leaving well alone for at least a parliament (preferably far longer!).

There will also be a call for government to underwrite or guarantee a minimum level of return in this space. Such a call is understandable in its aim, particularly given the current situation regarding fiduciary duty in the LGPS, if perhaps a little too rich for HM Treasury. Could a more palatable alternative be an LGPS Bond issued by the National Wealth Fund which would provide LGPS funds with an indexed linked future cashflow, effectively a form of government 'buy in' against an element of LGPS liabilities? This may also help support investment in UK for those LGPS funds who, due to the profile of their employer base and funding position, have a more bond-focussed strategy than others.

Investment in local communities

Local or 'place based' investment is already underway within the LGPS, however many of the opportunities in this area are smaller than LGPS pools would normally consider, therefore there is a risk that the desired growth may not be achieved.

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