Institute and Faculty of Actuaries

Investment Innovation and Future Consolidation

IFoA response to the Department for Work and Pensions

01 April 2019

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We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

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Institute and Faculty of Actuaries

Sinead Donnelly and David Farrar
Department for Work and Pensions Policy Group
Private Pensions and Arm's Length Bodies Directorate
Third Floor
South Quarry House
Leeds LS2 7UA

Dear Sinead and David,

01 April 2019

IFoA's response to Department for Work and Pensions (DWP) consultation Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution (DC) schemes

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the DWP's consultation *Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution schemes.*

2. The consultation has been considered by the IFoA's Finance and Investment Board and Pensions Board, who have experience and expertise both on investment in illiquid assets and on defined contribution pensions.

Responses to consultation questions

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' (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 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?

3. An asset based threshold would be more appropriate in our view, since relevant considerations around diversification/concentration are related to assets rather than membership. In addition, the size of members' DC pots is too variable to use membership as a proxy.

4. The threshold should also be simple to operate and should avoid sudden changes in treatment due to market fluctuations. For example, for schemes close to the boundary perhaps a window is needed, i.e. their assets need to be in excess of £1.0bn before reporting requirements are triggered, but reporting continues unless they fall below £0.9bn. An alternative test could be where assets have been in excess of or below a threshold more than once in, say, the last 3 years.

5. For illiquid assets £250m is a low threshold. The Prudent Person Principle might suggest an allocation of say 10% to 25% of scheme assets to illiquid assets, which is too small an investment unless pooling arrangements are possible.

6. Although we accept the practical need to set a threshold, one disadvantage of this is that schemes below that threshold are given a "free pass". If such schemes had to disclose their approach this would have the advantage of making it clear to scheme members that some investments are inaccessible due to the smaller scheme size. There could also be an unintended consequence of schemes close to the threshold trying to keep illiquid assets below that level to avoid onerous reporting.

(b) Reporting their policy: Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles

7. We support this proposal. Some guidance could be given as to what should be covered in the Statement of Investment Principles (SIP) to ensure a consistent approach across schemes.

(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.

8. We support the requirement to provide details of percentage holdings in illiquid assets, but we would note that this could be challenging given the complexity of collection of data from asset managers. The collection of asset data for Solvency II has been very complex, especially when providing look-through data.

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?

9. We believe that, above all, trustees should be encouraged to deliver a good quality DC scheme offering including aspects such as robust governance, asset class diversification and cost effectiveness. Consolidation might be a necessary consequence if it becomes clear that smaller schemes are struggling to achieve these outcomes due to their size. However, we would suggest that consolidation has started to happen, assisted by 'nudging' from the master trust regulations, changes to the bulk transfer value regulations and The Pensions Regulator's (TPR) regulatory approach (as acknowledged in paragraph 21 of Chapter 3). We are therefore not entirely convinced that the proposed measures are necessary yet. An alternative course would be to allow a period of bedding down, with the need for further 'nudges' reassessed in say 3-5 years' time. In the meantime, TPR will continue to regulate smaller schemes, and we expect it would challenge trustees where it perceives governance and outcomes to be poor.

10. If a decision is made to encourage consolidation now, we believe the Government should define this widely in order to minimise the degree of administrative disruption and cost, both of which could ultimately be detrimental to members. Examples of simple forms of consolidation might include investment trust structures or securitisation.

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 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.

11. The proposal is a good practical way to ensure DC members' best interests are being considered and we would support the need for small schemes to assess whether their members' interests could better be served through some form of consolidation.

12. If the DWP decides to proceed with this initiative, then an asset-related threshold would be more appropriate than a member-related one, as explained in Q1a above. However, it may not be appropriate to make all smaller schemes 'relevant' – for example, one- and two-member small self-administered schemes.

13. We note that the consultation gives an indication of the numbers of schemes affected relative to membership but not relative to £10m in assets. We believe it would be useful to consider both measures.

(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 significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?

14. Paragraph 27 of Chapter 3 mentions guidance on how to carry out an assessment. We believe this would definitely be needed, since trustees of smaller schemes are less likely to be advised by well-resourced advisers/firms.

(c) Reporting vehicle: The requirement could be added to the value for members assessment which forms part of the Chair's Statement and published annually.

15. We agree that this seems a sensible proposal.

(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.

16. We agree it would not be practical to carry out an assessment every year and that a triennial assessment might be reasonable. A requirement for additional assessments would need to be linked to lasting changes (not just market fluctuations, for example) and might require some guidance, or potentially a statement by the trustees as to why an additional assessment is not deemed necessary as a result of a significant change.

Q5. What do you think about the use of indicators such as trustee knowledge and understanding, 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?

17. We suggest that trustee knowledge and understanding is probably too subjective as an indicator. Status of the scheme could potentially be more appropriate, but, whatever the indicator, we would expect there to remain an option to explain why consolidation is not deemed appropriate, rather than permitting TPR to force consolidation.

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?

18. There is anecdotal evidence that some insurance companies favour performance fees on all their investment strategies i.e. including liquid asset mandates (for the reasons given by the consultation).

19. Performance fees are very prevalent in private market assets. Market practice is not changing sufficiently quickly to make equities more accessible to cost/fee constrained DC investors, however for debt there appears to be greater pressure on managers to accept fixed fees, especially for higher quality debt.

20. We acknowledge that there are pros and cons to both fee structures.

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?

21. We believe that the charge cap acts as both a hindrance and a help.

22. On the one hand, the charge cap is being used by DC schemes to drive down asset management fees. However, some asset managers are unwilling to reduce their fees and so access to these strategies will remain out of reach.

23. We would question the conclusion that the charge cap of 75bps is not a hindrance based on evidence that the upper end of the surveyed range of fees (38-54bps) is well below 75bps. It may be that awareness of the charge cap has forced an initial focus on a narrower set of asset classes and implementation vehicles, so that the 75bps cap forced the exclusion of some strategies.

24. We would also note that illiquid assets accessed through regulated markets are not a substitute for the diversification offered by private market investments.

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?

25. We believe the additional method of charges should be permitted. We assume that the extra 0.25% is a percentage of total funds under management at the start of the year. However, if it relates to the assets under management for that investment only, thought would need to be given as to whether there are opportunities for the approach to be gamed, i.e. we expect that this method may drive fund managers to look for a flat 75bps and therefore question if there is enough buyer leverage to push the 75bps down.

Q9. We propose that:

(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.

26. We would support guidance and believe it would be indispensable for less experienced trustees. However, making the correct choice of benchmark is a key decision for trustees and it is important that guidance on the fee structure does not distract from this.

27. We do not believe guidance should carry statutory weight. If DWP wants to pursue this, legislation would seem to be a more natural home for it.

(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.

28. It is not clear whether 'the value of the fund' means the whole fund or (which we would assume) just the value of the fund subject to performance fees. As above, we do not believe guidance should carry statutory weight.

(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees.

29. The reasoning behind the proposal seems sensible. We note that the government's inclusion in legislation of other permitted charges happened after the Office of Fair Trading's (OFT) report.

30. Although we assume that most large schemes apply charges solely on funds under management, NEST is a notable exception, so the proposals would seem to preclude NEST from investing in this way.

31. We also believe that a balance needs to be struck as to the frequency of valuation. The consultation says that International Organisation of Securities Commissions (IOSCO) best practice guidelines point towards 'frequent' calculations, but this term is not defined.

Q10 on p43. 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?

32. We suggest that the updated list could include wording along the lines of "if any item is not specifically on the excluded list, then assume it is included" (or vice versa).

Q10 on p45. 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.

33. The IFoA is not able to comment on the scale of costs associated with the proposals. However, we would note that the costs of any additional reporting and considerations regarding consolidation will depend on the level of detail and prescription required or expected by TPR. We can envisage a range from something relatively simple and inexpensive through to an exercise requiring trustees to seek significant additional information and professional advice, so it will be important to keep in mind the potential benefits, and costs, for members when designing the guidance.

If you wish to discuss this response in more detail, please contact Matthew Levine, Policy Manager (matthew.levine@actuaries.org.uk).

Yours Sincerely,

Kartina Tahir Thomson
Member of Council, Institute and Faculty of Actuaries