ABI Response to DWP Consultation on Investment Innovation and Future Consolidation

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Introduction

The Association of British Insurers (ABI) is the voice of the UK's world leading insurance and long-term savings industry. A productive, inclusive and thriving sector, we are an industry that provides peace of mind to households and businesses across the UK and powers the growth of local and regional economies by enabling trade, risk taking, investment and innovation. The UK insurance industry is the largest in Europe and the fourth largest in the world. It is an essential part of the UK's economic strength, managing investments of over £1.8 trillion and paying nearly £12bn in taxes to the Government. It employs around 300,000 individuals, of which around a third are employed directly by providers with the remainder in auxiliary services such as broking.

Executive Summary

1. The ABI welcomes the opportunity to respond to the Department for Work and Pensions consultation, having previously responded to the Government's Patient Capital Review. UK insurers and long-term savings providers collectively manage 20% of the UK's total net worth and have a natural role as suppliers of patient capital, given the long-term and illiquid nature of a large part of their liabilities.

2. The ABI is supportive of the proposals put forward in the consultation regarding consolidation of Defined Contribution (DC) schemes. The benefits of scale are clear and encouraging consolidation will not only benefit savers but drive efficiency in the entire long-term savings industry.

3. The ABI is and has previously been supportive of the Government's proposals and initiatives to increase investment in patient capital, however, there are considerable contractual and regulatory barriers for insurers to invest in illiquid assets. The decision to invest is a commercial one and therefore the risks of the investment would need to be considered, as well as how it fits within the overall portfolio and what customer needs are. As the UK insurance and long-term savings industry holds a large percentage of the capital that could be invested in private equity and illiquid assets the ABI recommends that Government and regulators increase the flexibility insurers need in order to properly consider investing in patient capital.

4. To further stimulate investment in illiquid assets the ABI recommends that Government study what effect exempting performance fees from the charge cap would have on investment in illiquid assets.

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?**
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> **(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**
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> **(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.**

5. The ABI supports the principles of the Governments proposals to encourage pension schemes to invest in illiquid assets. Schemes should be required to explain their policy towards investment in illiquid assets and on their main default arrangements although the ABI doubts whether a disclosure nudge will have a substantial impact due to other barriers to such investments. Long-term assets can be a good match for long-term liabilities such as infrastructure and green energy. Insurers and long-term savings providers are natural long-term investors as they seek to match their investments with their long-term commitments to policyholders. As an example, insurers and long-term savings providers have been funding long-term, major infrastructure projects for decades. However, due to the contractual obligations insurers have with their policyholders they will not invest unless it makes sense from a risk/return perspective towards whom they have contractual obligations. The investment decisions of insurers and long-term savings providers are commercial decisions, and the trade-off between potential returns and the risk associated with investment in illiquid assets and in private equity pose a barrier to investment.

6. There are regulatory considerations that impose barriers for insurers to invest in illiquid assets that the Government should take into consideration when encouraging pensions saving to be used for investments in illiquid assets. Solvency II, the European prudential regime for insurers, includes a number of provisions that need to be considered by an insurer when deciding whether to invest in a particular asset. In particular, the prudential treatment of patient capital investment under Solvency II makes such investment capital intensive. This is not just due to the capital requirements that insurers are required to hold under the regime, but also due to the fact such investments are unlikely to be eligible for the matching adjustment (a measure that reduces capital intensity). Compliance with the Solvency II prudent person principle will also impact on firms' investment. In combination, the prudential requirements lead insurers to favour long-term assets where the risks and future cash-flows are clearly visible.

7. Given the size of the UK insurance and long-terms savings sector, the ABI believes that greater regulatory flexibility should be given, which could improve current weaknesses in the supply of patient capital. Greater regulatory flexibility could reduce the capital and other

cost implications insurers face when making patient capital investments, and it would also improve the return from these investments.

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?
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.**
> **(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?**
> **(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.**
> **(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.**

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?

8. The ABI supports the Government's proposals of encouraging smaller DC pensions schemes to consolidate and extending the Chair's Statement to cover consolidation.

9. There is a growing body of evidence showing that smaller DC schemes are struggling to demonstrate that they provide value for members (VFM) and that smaller pension schemes are not providing adequate information in their Chair's Statement. The Pension Regulator (TPR) found in their annual survey of DC trust-based pension schemes that the trustees of just 10% of small schemes and approximately 33% of medium sized schemes are doing everything which TPR believes is essential to asses VFM.[1] In their thematic review into value for members in small and micro pensions schemes TPR reviewed 68 chair statements, finding that in 37% of cases no VFM assessment had been carried out. TPR judged that over 50% of statements provided inadequate or incomplete explanations of how the costs and charges imposed by the scheme represent good VFM.[2]

10. Consolidation would not just benefit members of those DC schemes which consolidate but would improve the efficiency of the whole sector. Schemes with poor data and manual processes are a drag on the performance of the industry as a whole, and this adds costs to all participants. We are well aware that size and efficiency are not perfectly correlated,

[1] Defined Contribution trust-based pension schemes research, The Pension Regulator, September 2018
[2] A Thematic Report: How trustees of small and micro DC schemes are assessing value for members, The Pension Regulator, September 2018

but larger schemes are better able to achieve efficiency. This is illustrated by the fact that DWP has proposed that small schemes are exempt from the requirement to make data available to customers via pensions dashboards; and the difference between some occupational pension schemes and FCA-regulated firms in pension transfer times.

11. When defining 'relevant schemes' the ABI would like to see the Government use the monetary definition of £10m in assets as this is a truer indication of scale. By following this definition, the Government will ensure that a considerably larger number of schemes, 93% of occupational DC schemes compared to 52% for the membership sized definition, are required to report on the potential benefits of future consolidation to members.[3] The ABI does not believe defining scheme member size would be a good gauge for the need to consolidate.

12. The ABI favours the Government's proposal of requiring the Chair's Statement to include an assessment if it is in the member interest to consolidate. When expanding the Chair's Statement to include consolidation all guidance around the statement needs to be reviewed, to be clearer on what should be included and to ensure members get the benefits they deserve from their pensions.

13. Schemes should be required to explain their assessment to members. All elements listed in 3B (charges, investment, governance and administration costs) should be compared, a reference and additional guidance to help members fully understand the assessment would also be helpful. The comparison should be available along with the assessment in the Chair's Statement to members of the scheme. However, any reference should be clear that good governance can include contract-based schemes.

14. The ABI suggests that when a scheme produces their assessment on consolidation it should be submitted to TPR, if the assessment deems that action is required it should be accompanied by an action plan which the regulator would need to agree to and work with trustees to implement. Any scheme which is unwilling or unable to provide a robust assessment of VFM should consider consolidation into a larger scheme to allow members to benefit from economies of scale.

15. With regard to reporting frequency mentioned in question 3D, the ABI agrees with the proposal. Schemes should be required to produce an assessment regarding consolidation every three years.

16. The Government should continue to explore measures to prompt and enable schemes to consolidate, and once the impact of the change proposed in the consultation has been assessed, consider whether to introduce further measures. For example:
    a. Making bulk transfers without consent between occupational schemes and contract-schemes (and vice versa) easier;
    b. Legislating for a power to direct schemes to consolidate.

17. The ABI recommends the DWP and TPR not to implement any new rules or recommendations relating to DC consolidation until after the Master Trust authorisation process has been completed and the market has had time to adjust to the new regime. If smaller schemes are going to consolidate, they may choose to utilise a master trust

[3] DC trust: presentation of scheme return data 2017 – 2018, The Pension Regulator, January 2018

offering. It is unlikely that trustees of the smaller schemes would want to commit to master trusts during or shortly after the authorisation process.

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?
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?

18. The majority of DC pension funds sit in workplace pension schemes, mainly in default funds. These funds are either overseen by trustees or an Independent Governance Committee (IGC) but usually already exist as part of the overall scheme/product design. To encourage these funds to invest in private equity or illiquid assets, the managers of the schemes' investment strategy would need to have a solid evidence base that investing part of their assets in private equity or illiquid assets will deliver superior long-term returns without exposing the fund to excessive risk. Trustees and IGCs also need to be persuaded that including a wider asset mix within default funds will deliver better outcomes for their scheme members.

19. There is a considerable difference in investing funds in illiquid assets and private equity to investing them in default funds. Default funds tend to invest in passive component funds where investment management activity is restricted to asset allocation rather than more labour-intensive selection of specific investment. These funds track indices such as 'All Share' or 'All Stocks'. Private equity, venture capital and patient capital are therefore excluded as they are not listed on any of the indices tracked, if listed at all.

20. Performance fees are common practice within private equity, venture capital, in the private debt space and in private markets. For DC pension funds the only assets typically used are property and listed private equity. The ABI has no view or data on whether these trends are changing.

21. There are several barriers to employing performance fees in unit linked funds, the primary one being the complexity in applying a charge that might be variable to a daily priced fund. Performance fees generally also include higher charges than what traditional assets do, which causes problems with regards to the charge cap. Performance fees are based on future performance, however, under the current system and this consultation proposal they would have to be based on historic performance once disclosed.

22. If performance fees were assessed against the charge cap it would mean a lower target exposure than what may be optimal from an investment perspective. Further, this could lead to assets being constrained due to the headroom that would need to be maintained.

23. The ABI recommends that the DWP study what effect exempting performance fees from the charge cap would have on encouraging investment in private equity and illiquid assets.

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?

24. Nothing further to add

Q9. We propose that:

> **(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.**
> **(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.**
> **(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees. We would welcome respondents' views on all these points.**

25. Our industry would be supportive of further guidance on performance fee structures. Any guidance which is produced would have to address the issues previously mentioned in this consultation on unit pricing and performance fees.

Q10. 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?

26. Nothing further to add

Q10. 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.**

27. Assuming that a scheme has a view on illiquid holdings it should not be difficult or costly to create a policy on it.

28. Costs for reporting on illiquid assets would depend on what was required to report. If there were to be rules brought in to mandate reporting on illiquid holdings it is imperative that they not be burdensome to follow.