THE INVESTMENT ASSOCIATION

**DWP DC Policy, Investment & Governance Team**
pensions.investment@dwp.gov.uk

**The Investment Association**
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

+44 20 7831 0898
imran.razvi@theia.org
theia.org
@InvAssoc @The Investment Association

10 May 2022

Dear DC Policy, Investment and Governance Team,

**RE: Investment Association Response to DWP consultation on 'Facilitating investment in illiquid assets'**

The Investment Association[1] (IA) welcomes the opportunity to respond to the DWP's consultation on facilitating investment in illiquid assets. It is critical that DC schemes can build investment portfolios capable of delivering the best outcomes for their members and deliver the long-term investment that the economy requires. An allocation to illiquid assets may contribute to these goals, and we welcome both the Government's response to the consultation on exempting performance fees from the charge cap, and the 'disclose and explain' proposals set out in the paper.

We have provided answers to several questions, but also have a number of broader comments:

**1. The future status of performance fees under the default strategy charge cap:** We welcome DWP's decision to go ahead with excluding well-designed performance fees from the cap – despite the mixed response to the proposal – and we look forward to engaging further as the policy develops. We believe well-designed performance fees can strengthen the alignment of interests between investment manager and client and excluding them from the cap will give those DC schemes that wish to use them the flexibility to do so. We

[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage over £9.4trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. That is 13% of the £75 trillion global assets under management.

recognise some of the concerns around performance fees but think these can be allayed by trustees using a combination of appropriate hurdle rates, high-water marks, and a fair level of profit share, allied with clear disclosure. We are happy to work with DWP to develop guidance in this area and note the work of the Productive Finance Working Group (PFWG), whose forthcoming trustee guide on performance fees should be a strong starting point. We urge the DWP to finalise the policy as quickly as possible, as uncertainty over this issue will delay the launch of illiquid products to the DC market, including new Long-Term Asset Funds (LTAFs).

**2. 'Disclose and explain' policy proposals:** We welcome these as they provide further transparency for DC savers and will bring additional scrutiny to investment decisions made by DC trustees. We provide more detailed comments in our answers to the specific questions, but agree with the Department that overall, while these disclosures increase transparency and are helpful, they are not a panacea for increasing illiquid investments in DC. Achievement of this will depend on a number of other measures, notably the FCA/TPR work on a 'value for money' framework and the broader PFWG work on changing the focus in DC from cost to value.

**3. Addressing the barrier to illiquids posed by daily liquidity:** There is an additional operational barrier which will continue to create a challenge unless addressed: the convention for DC schemes to offer daily liquidity. Feedback from our members and their clients is that DC investment platforms, are, in the main, not yet able to deliver access to non-daily dealt funds with notice periods, such as the LTAF. It is frequently the case that pension schemes and platforms say that non-daily dealt funds are not appropriate for DC. The resulting inability to distribute such funds will hamper their development by investment managers, and hence their uptake by DC schemes.

In our view, a better place for the DC industry to get to is to recognise that illiquid assets are not consistent with daily liquidity. Default portfolios could have a liquid, daily priced and traded component (the majority – 90-95%) and a small illiquid component that is priced and traded in a manner that reflects the liquidity profile of the underlying assets. In doing this, schemes should articulate to members the benefit to their overall outcome from giving up daily liquidity on the illiquid element of the portfolio.

To achieve this broader DC industry shift away from daily liquidity, a number of steps are necessary on the part of regulators, as well as from participants in the DC investment value chain. From regulators, a strong signal is needed on what good looks like in DC investment. This includes a view on the appropriate role of daily liquidity in DC investment over time. The PFWG, which brings together all the relevant regulators and policymakers, is well placed to send this signal.

On the supply side of the DC investment market, investment managers are already looking to develop non-daily dealt illiquid products such as LTAFs, and platforms should seek to make the necessary operational adjustments to host such products, delivering innovation and increased choice for DC schemes.

On the demand side of the market, the DWP's proposed intervention will help schemes think further about the role of illiquid assets in their portfolios. However, we think this could be further strengthened with an additional element that focuses explicitly on operational matters such as the provision of daily liquidity. To that end, we recommend that the illiquid policy statement should also include a discussion on the extent to which the scheme's investment implementation capabilities constrain its ability to invest in illiquid assets. This could explicitly cover the extent to which daily liquidity is a barrier, along with any other operational challenges that constrain the scheme when implementing its investment strategy.

We also recommend the FCA consider a similar requirement for insured pension providers and their IGCs to formulate and disclose policies on illiquid investment, including a focus on the impact of daily liquidity and any other operational constraints. This will achieve consistency in the consideration of illiquids across the DC market.

Alongside this, as the FCA and TPR develop their DC value for money framework, investment implementation via platforms should be one of the key areas for assessment.

These measures would encourage trustees, insurers and IGCs to think explicitly about daily liquidity and other operational issues and would be a signal that regulators do not consider daily liquidity to be in members' interests all the time. It may create the necessary momentum needed to soften the daily liquidity convention in DC and pave the way to greater adoption of illiquids.

I hope this response is helpful and I would be delighted to discuss it further.

Yours Sincerely,

**Imran Razvi**
**Senior Policy Adviser, Pensions & Institutional Market**

# Response to selected consultation questions

## Chapter 2: Introducing 'disclose and explain' policy proposals

**Q1: Do you support these proposals and agree with the government's rationale for intervention?**

We believe that illiquid assets may offer DC members the chance to improve their pension outcome through enhanced returns and greater diversification, and that while they may not be right for all schemes in the end, consideration should at least be given to their inclusion in default strategies.

Notwithstanding this, in 2019 we were sceptical[2] of the Department's proposals around illiquid asset reporting. At the time we did not see a clear rationale for singling out illiquid asset classes, since it gave the impression that investing in them was an end in itself, rather than as part of a broader investment strategy optimised to deliver better member outcomes.

However, since those proposals were first consulted on, there has been much discussion around the adoption of illiquids in DC, yet actual investment in such assets continues to be low. While it continues to feel odd to single out illiquid asset classes, we acknowledge that a new approach may now be needed. In that context we believe that the DWP's proposal is an appropriate nudge-based approach that will encourage trustees to think about the potential role of illiquids in their default strategies.

The proposal to require disclosure of default asset allocation is more straightforward. It is an importance piece of transparency for scheme members and market commentators and will help bring greater scrutiny to scheme investment decision-making. We do not consider this requirement to be burdensome for schemes since the information is easily obtainable from their platforms and investment managers, indeed many schemes are likely to provide this information already.

**Q2: Do you agree with the scope of this proposal?**

Yes, we agree with the scope of the proposal on disclosure of an illiquid assets policy. Given the trend in the DC market towards consolidation, which regulators are encouraging, nudging small (sub-£100m) DC schemes towards illiquids may be an impediment towards further consolidation (if those assets need to be sold as part of the scheme wind-up process). In addition, some smaller schemes may lack the additional governance resource required to manage an illiquid allocation.

We also agree that DB schemes should be exempt from the proposal. As the consultation notes, some DB schemes have already adopted illiquids. In general, the DB investment market has historically seen more innovation than DC, as a result of an investment process

[2] IA response to 'Investment innovation and future consolidation', March 2019. Available at https://www.theia.org/sites/default/files/2019-04/IA_response_to_DWP_investment_innovation_CP_March_2019.pdf

that has focused on the delivery of outcomes rather than cost alone, and we do not see the need for a specific intervention around illiquids in that market.

**Q3: Considering the policy objective, to require trustees to state a policy on investment in illiquids, how should we define "illiquid assets"?**

Conceptually we think it is most useful to think of illiquidity at an asset class level. Funds are simply a structure for holding assets, and are themselves neither inherently liquid or illiquid, in any case typically containing a mixture of liquid and illiquid assets. Thinking about illiquidity at the level of the vehicle would also preclude direct holdings of an asset.

The consultation highlights a number of the challenges around defining illiquid assets and we are doubtful that it is possible to have a precise definition. Illiquidity covers a spectrum rather than a binary division between 'liquid' and 'illiquid', and there is also a temporal element in that liquidity in an asset can dry up under certain conditions. The risk of attempting to precisely define illiquid assets in regulation is that it creates a sense of 'approved' asset classes and does not allow for the development of new asset classes over time.

We believe that a better approach would be to leave the term undefined and allow trustees and their advisers to form their own view on what constitute illiquid assets. The market has an intuitive understanding of the concept, and we think it is both unnecessary and undesirable to precisely define the term in regulation. If the DWP is concerned about trustees' ability to identify illiquid assets, it could publish guidance with some examples, although there is already plenty of material freely available to trustees in the marketplace.

**Q4: Do you agree with the proposed aspects of a scheme's illiquid asset policy that we would require to be disclosed and timing of such disclosures?**

Yes, we agree both with the proposed aspects that a scheme's illiquid asset policy should cover in the SIP disclosure, as well as the timing of the disclosures.

As we have explained in our cover letter, we believe there is merit in adding an additional point into the illiquid policy disclosure around the extent to which the scheme's investment implementation capabilities constrain its ability to invest in illiquid assets. This could explicitly cover the extent to which daily liquidity is a barrier, along with any other operational challenges that constrain the scheme when implementing its investment strategy.

By encouraging trustees to actively consider the appropriateness of daily dealing for their members, this may help to alleviate the barrier to investing in illiquid assets by giving trustees the confidence to invest in truly illiquid non-daily dealt funds, and to give platforms the demand signal that a shift away from daily dealing for illiquid assets is desired by the market. This element of the illiquid policy statement would also be a helpful signal to the market that regulators do not believe daily dealing is always necessary and desirable. Such a signal would further signal an acceptance of non-daily dealing in illiquid funds.

**Q5: Do you agree that with the proposed level of granularity for this disclosure? Are the asset classes and sub-asset classes proposed in the example above appropriate for this kind of asset allocation disclosure?**

Yes, we agree with the proposed level of granularity for the asset allocation disclosure and the proposed sub-asset classes. We consider this information to be a minimum level of transparency that should be available to scheme members over the composition of their portfolio. We note that several providers across both the trust and contract-based DC markets already provide such information and putting it on a statutory footing for occupational schemes will result in consistent availability of this information across the market.

We also support the DWP's proposal to produce guidance on how trustees should disclose their default asset allocations. This will help ensure consistency in reporting across the market and is also capable of being easily adapted as the market for illiquid investment products evolves.

**Q6: Do you agree that holding £100 million or more of total assets in an appropriate threshold for determining which DC schemes should be required to disclose asset allocation?**

We do not agree with the threshold and instead believe that all DC schemes should be required to disclose their asset allocation. It is not clear why members of smaller schemes deserve less transparency over their portfolios than members of larger schemes. Nor do we consider this a burdensome requirement for any scheme: the information can easily be obtained at the level of granularity proposed by the DWP from product disclosures made available by DC platforms and investment managers.

**Q7: Do you agree that we should align the disclosures with the net returns' disclosure requirement?**

We believe that time to retirement would be the optimal approach for showing the variation in asset allocation over time, since it is really the retirement date rather than age that is the driver of changes in DC asset allocation over time. However, we recognise that harmonising asset allocation disclosures with the net returns' disclosure requirements around age cohorts will be easier for schemes, and this may be a more pragmatic approach. In any case we would not expect age-related disclosures to differ too widely from an approach based on time to retirement.

**Q8: Do you agree with the frequency and location of the proposed asset allocation disclosures?**

Yes, we agree with the frequency and location of asset allocation disclosures. Since asset allocation is a significant driver of investment returns, it makes sense to present it in the same place as the net return disclosures. Ideally these should be presented alongside each other.

## Chapter 3: Employer-related investments

**Q10: Do you think the current regulations relating to ERI in the 2005 Regulations present a barrier to Master Trusts expanding investment strategies to include private debt/credit?**

We have heard feedback from pension schemes that the current ERI regulations can have a negative impact on their ability to access certain private asset classes. While schemes and their lawyers are better placed to comment on the detail of the revised regulations, we support the DWP's policy intention in relation to ERI and agree that the law in this area should reflect changes in the nature of commercial pension provision since these rules were first introduced.