THE
INVESTMENT
ASSOCIATION

DWP DC Reform Policy Team
Sent by email to quarryhouse.pensionsinvestmentreviewdcreforms@dwp.gov.uk

16th January 2025

Dear DC Reform Policy Team,

RE: Investment Association response to 'Pensions Investment Review: Unlocking the UK pensions market for growth'

The Investment Association (IA) welcomes the DWP's consultation on proposed reforms to build further scale in the workplace DC pensions market. There is an important opportunity here both to harness efficiencies and enhance the way in which investment decision-making takes place to the long-term benefit of scheme members and with positive impacts on the UK economy, particularly where private market allocations are better facilitated.[1]

In addition to responses to specific consultation questions below, we would like to emphasise a number of points as follows:

1. **The central importance of 'sophisticated scale'.** Size is a facilitator, but not a panacea. Large pension schemes will only be world-class pensions schemes if they can invest at scale in a sophisticated way, based on:

- strong investment governance and oversight, with high standards of accountability;
- appropriate levels of investment expertise that covers knowledge of investment opportunities across the full range of asset classes and markets, including more niche areas; and
- sophisticated investment procurement that considers where internal and external management can add value, as well as being able to identify and work with a wide range of investment managers, from small, specialised firms to large global managers.

These are therefore the features needed for DC schemes to deliver the best investment outcomes for their members. The creation of such investment governance and implementation frameworks requires deliberate and thoughtful action at scheme level. The consultation proposals provide a foundation for greater scale but do not, in and of themselves, provide a roadmap to sophisticated scale. More emphasis will be needed from regulators to support pension schemes: for example, setting out their view of what best-in-class investment governance and delivery frameworks look like, based on case studies from asset owners both from the UK and globally, and then engaging with DC schemes to support their efforts to implement these frameworks.

The challenge of shifting DC delivery culture away from an undue focus on price towards a broader emphasis on value should not be underestimated. Depending upon how other aspects of the drive to scale

[1] 'Investing for Everyone's Future – A Response to the Pensions Investment Review: Call for Evidence', IA, 2024

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are implemented, there is a risk that the scale process simply further embeds a focus on price competition as a core differentiator. This is because schemes and providers may continue to feel too constrained by market dynamics to increase charges to a level that would allow for investment in more expensive asset classes which on a net basis can often deliver greater returns and downside protection, which in turn leads to better member outcomes in retirement.

2. Thresholds for minimum scale create new risks. Fragmentation, especially the high number of very small schemes, needs to be addressed with measures that avoid unintended consequences. Setting a minimum threshold in legislation for Assets under Management (AuM) or limiting the number of default funds may incentivise 'asset gathering' over innovation and negatively impact smaller, innovative providers seeking to enter (or remain in) the market. It may also complicate DC schemes' abilities to build well-diversified investment strategies, both in accumulation and retirement. The overall impact is likely to be a less dynamic market, with near-guaranteed flows for a small group of select providers. This could lead to herding in investment strategies across the market and a lack of innovation in DC investment, not more.

A principles-based supervisory approach that emphasises sophisticated scale and relies on consistent and high standards of scheme governance (including appropriately diversified investment strategies), rather than a fixed numerical target, could better support the development of high-quality, diversified investment strategies. This could also be designed to drive consolidation among smaller schemes unable to demonstrably meet these standards. Regulators should monitor scale metrics but prioritise governance to enhance the DC investment process and engage with DC schemes to support them in building these high-quality governance processes.

3. Transfers out of contract-based arrangements without member consent should be permitted. We agree that mechanisms need to be found to trigger non –consent-based transfers out of contract-based schemes, in order to safeguard member outcomes. This could be done following an assessment by an IGC or independent expert. For those members transferred in this fashion, employers should have a role to play in identifying a new scheme to receive incoming transfers, a role that aligns well with their automatic enrolment duties.

4. Advisers, and possibly employers, could play a greater part in the culture shift from cost to value. Given the challenges that pension providers face in competing on factors other than cost, it is important to look at the role that advisers as well as employers can play in helping shift the market dynamic.

If done carefully, the regulation of advice, both over scheme selection and investment, could allow regulators to help steer the market away from a narrow focus on cost to a broader focus on value. Regulators could direct advisers to avoid placing an over-emphasis on cost in scheme selection and investment decisions, instead emphasising value. Regulation of investment and scheme selection advice also means that regulators can assess the advice given to ensure the relevant regulatory requirements are taken into account.

Employers could play a formal role in driving competition in the market by being required to carry out a periodic review of their scheme, based on the advice received from Employee Benefit Consultants (EBCs) and Investment Consultants. This should build on their existing duty to automatically enrol their employees into a qualifying scheme and may need to be targeted at larger employers to avoid undue burdens on small and medium-sized enterprises (SMEs). We do not support imposing a more specific value assessment requirement since many employers, particularly smaller ones, may not feel comfortable with additional responsibilities in an area in which they are not expert.

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

Yours sincerely

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Response to consultation

PENSIONS INVESTMENT REVIEW: UNLOCKING THE UK PENSIONS MARKET FOR GROWTH

About the Investment Association

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 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.1 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 49% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Response to selected consultation questions

Chapter 2: Achieveing scale in the Defined Contribution market

1. **Do you think that providers should be restricted to a limited number of default funds, and if not, why? Please consider any equality considerations, conditions and to what extent saver choice could be impacted.**

2. **The proposed approach at default fund level could mean that the number of default arrangements would remain unchanged. Will imposing the requirement at this level have any impacts on the diversity of investments or the pricing offered to employers?**

Combined answer to Qs 1 and 2

While we have reservations over a specific Assets under Management (AuM) threshold (see our answer to Q4), if the government does choose to implement a minimum size of AuM at the default fund level, we see no benefit in a further requirement that regulates for the number of default funds used.

The consultation notes that the terms *"default investment', default arrangement, default fund, default fund arrangement and default investment fund….often appear to be used interchangeably."*[2] For the avoidance of doubt, when we discuss the default, we mean the term "default arrangement" as defined in regulation (3) of the 'The Occupational Pension Schemes (Charges and Governance) Regulations 2015' or, equivalently, in the FCA Handbook Glossary.

Defined thus, the default refers solely to the arrangement that contributions are invested into in the absence of an active member choice – and not the underlying pooled vehicles that make up the default. **In the context of DC schemes, scale should be considered at the default arrangement level and not at the level of the underlying pooled funds**.

Most importantly, applying any minimum AuM requirement at default arrangement level achieves the government's intended policy objective of minimum scale at the correct level of investment structure. It also avoids placing arbitrary constraints on the construction of default arrangement portfolios: DC investment strategies are generally constructed using multiple pooled vehicles as building blocks that

[2] Paragraph 31 of the consultation.

together form the desired investment strategy, with appropriate risk and return characteristics. It is common industry practice for many of these strategies to invest in underlying pooled vehicles in a Fund-of-Funds structure. It is often the case that these underlying building blocks are large funds in their own right, aggregating the investments of a broad pool of investors beyond just the UK DC market, and bringing the benefits of scale and professional investment management to all investors in the fund. Arbitrarily limiting the number of pooled vehicles a DC default arrangement could invest in ignores the scale at the underlying pooled vehicle level, and would negatively impact the ability of DC schemes to implement their desired strategies, by limiting the number of building block funds they could use.

3. What do you think is the appropriate minimum size of AuM at default fund level within MTs/GPPs for these schemes to achieve better outcomes for members and maximise investment opportunities in productive assets?

The DWP evidence paper published alongside this consultation provides a helpful summary[3] of the correlation between scale and various benefits, although the precise size at which these benefits arise seems to be variable. While we are supportive of the drive to create scale in the DC system, it is not necessary to legislate for a minimum size: any precise number will be arbitrary, and hard coding a specific number into legislation brings its own issues (discussed in our answer to Q4).

While much focus is on the Australian DC system as being worthy of emulation by the UK, it is often overlooked that the current scale of the Australian Superannuation market is a function of the longer time period the reform has been in place (since 1992); its mandatory nature; and, critically, the fact that its contribution rates have been higher than the UK's 8% since 2002 (these currently stand at 11.5% and are scheduled to reach 12% next summer). Setting a minimum threshold today for some future point, when there is a lack of clarity over how the UK DC market will evolve in areas such as contributions, participation rates and investment strategies and performance, risks any number becoming outdated.

As we have previously noted, what is most important beyond a narrow focus on scale is the kind of sophisticated scale that leads to a genuine enhancement of the investment process: more diverse capital allocation across all segments of the private and public markets, accompanied by strong governance and oversight; accountability; investment expertise; and sophisticated procurement methods that consider where internal and external management can add value, as well as being able to identify and work with a wide range of investment managers, from small, specialised firms to large global managers. These features are not automatic, with the implementation of appropriate governance and delivery frameworks being a deliberate step that schemes must take.

Policymakers and regulators should therefore be focused on ensuring that pension schemes put these frameworks in place and that they function effectively on an ongoing basis. This is more important to delivering good investment outcomes to scheme members than focusing narrowly on the achievement of a specific minimum threshold for scale.

This does not preclude the possibility of the Government and regulators setting an expectation of the requisite scale and then relying on regulatory supervision by the FCA and TPR to help drive consolidation where scheme members would benefit from better delivery. But the focus should always be on ensuring that schemes are set up to deliver the best investment outcomes.

[3] Table 6, p32, 'Pension fund investment and the UK economy' DWP, 2024

4. Are there any other flexibilities or conditions needed regarding the minimum size of AuM (e.g. should it be disapplied in circumstances at regulators' discretion, for example to enable an innovator to provide competitive challenge in the market, or be disapplied in the case of a market shock or another specified circumstance)?

The immediate consequence of setting a hard number on minimum AuM is that schemes and regulators will be focused on managing around the need to avoid falling below the threshold. It will necessitate the need for mechanisms to take account of temporary drops below the threshold due to events such as market movements or bulk transfers, introducing further complexity into the legislation. It would incentivise 'asset gathering' over innovation and, as the question hints at, would be to the detriment of smaller, innovative providers seeking to enter the market – unless a further carve out (adding to legislative complexity) is created for such providers. Finally, to the point made in our answer to the previous question, it distracts from a proper focus on ensuring that pension schemes have in place the appropriate investment governance and delivery frameworks and that these are functioning well.

For these reasons, it would be better to take a principles-based approach to scale rather than mechanistically applying a quantitative threshold.

5. Do you think there should be targets for (i) achieving a reduction in default fund numbers down to a single fund and (ii) setting incremental minimum AuM?

6. Are there any potential barriers/challenges that should be considered in reaching a minimum size of AuM at default fund level before a future date, such as 2030?

<u>Combined answer to Qs 5 and 6</u>

In line with our answers to the previous questions we do not think formal incremental targets on default arrangement numbers and AuM are especially helpful under the principles-based approach to scale that we advocate. Regulators can monitor these metrics to take a view about how schemes are evolving, but we reiterate the importance of a focus on governance rather than scale alone.

Setting a minimum threshold today for a future date means any target may be at risk if there are any unforeseen market events or policy developments that affect a scheme's ability to reach the target date in future. On the upside, if DC assets were to grow quickly and significantly, a future target may become irrelevant by the time it comes into force.

The concern is that the target becomes the focus in its own right rather than the development of governance and implementation frameworks that enhance the DC investment process and reinforce the shift from price to value.

7. Given the above examples, what exclusions, if any, from a required minimum size of AuM at default fund level and/or the maximum number of default funds requirement should government consider?

This question shows recognition by the Government that an arbitrary scale target is not in itself a driver of good outcomes from DC schemes. To emphasise the point again, it is the focus on sophisticated scale that leads to an enhanced investment process and better member outcomes. Our view is that regulators should be setting out their view of what best-in-class investment governance and delivery frameworks look like, based on case studies of asset owners both from the UK and globally, and then assessing DC schemes against that framework.

8. With regards to the proposals in this chapter, we anticipate the need for mechanisms to encourage innovation and competition, and for safeguards to protect against systemic risk. Are there any other key risks that we need to consider? How do we mitigate aginst them?

Concerns around reduced competition and innovation, allied with increased systemic risk are the key risks that we consider arise from DWP's consolidation proposals.

On competition and innovation, given the scale expected in this market we have significant concerns that the DC market could end up looking like a utility. With the near guarantee of significant on-going inflows purely as a result of being one of the few remaining providers, we see little competitive pressure to innovate. This concern is heightened when further combined with application of the proposed DC Value for Money Framework. As we set out in our response[4] to the FCA's October 2024 consultation[5], cross-scheme comparisons, the 'Red-Amber-Green' ('RAG') rating process and the new business ban in combination will have significant detrimental consequences for market innovation, with DC schemes best served by not standing out from one another. This may lead to herding in investment strategies across the market and a lack of innovation in DC investment, not more.

The market will need careful monitoring by competition authorities to mitigate the risks set out in the previous paragraph. In this regard, we note that there is quite a complex landscape for pensions, given that FCA does have formal competition responsibilities, but TPR does not. Although we envisage there would be a role for the Competition and Markets Authority at an overarching level, it is worth considering how best to embed the need to avoid over-concentration and a lack of competition into the regulatory oversight of the pensions system as a whole.

Systemic risks are a further concern. A concentration of assets with a small number of providers, in the event of a provider failure or market crisis, could have highly negative impacts on member outcomes and damage confidence in the DC industry. This may be heightened if the lack of competitive dynamics highlighted above results in herding in DC investment strategies, in which case all schemes will see similar negative impacts from the same market shock. The correlation of such outcomes will mean the entire DC sector being badly affected.

Finally, we note that since the current proposals provide no incentives or roadmap to create the 'sophisticated scale' that is really required to deliver excellence in DC investment, there is a risk where the additional scale simply leads to larger pension schemes without changing their governance, accountability and their underlying investment process from that which characterises parts of the DC market today. If this were to happen, we foresee little change in the DC market, which will likely continue to focus on price competition and have lower allocations to private markets and other new asset classes relative to other investor types. The Government could mitigate this risk by having regulators place more emphasis on what features should characterise the governance and delivery process for DC investment in practice.

9. Under a minimum AuM model, competition in the market could be more restricted. Would additional exceptions be required to ensure innovation can continue to flourish?

The consultation focuses on CDC schemes as an example of future innovation that could be negatively affected under the minimum AuM model. However, the point is true of any new innovation in pension provision. If the government is serious about letting new innovation disrupt the market and promote competition, while implementing a minimum AuM model, then exceptions to the minimum AuM will be critical. However, this does then lead to the uncomfortable position of government and regulators setting out what they see as innovation that is worthy of exemption, rather than letting the market innovate. This

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[4] IA response to FCA CP24/16

[5] CP24/16 'The Value for Money Framework'

further underscores the need to avoid applying a hard minimum AuM figure and instead taking a proportionate view that focuses on the value a provider brings.

10. We would welcome views on what further interventions or regulatory changes might be necessary or beneficial to accelerate this process?

Our response to the Pensions Investment Review Call for Evidence set out that post-transaction operational difficulties of effecting a master trust merger (e.g. the combination of investment strategies, administration strategies, etc) are a barrier to further consolidation. These arise from the master trust legislation, accompanying regulations and TPR's Code, which contain a series of requirements around "triggering events", designed primarily to protect members in the event of the failure of a scheme funder.

This issue could be addressed through the creation of an additional "Scheme Merger" Triggering Event and a corresponding Continuation Option which would cover the consolidation of one master trust into another through a corporate transaction between the funders. This would enable the receiving scheme to remain open for business whilst both sets of trustees engage with the regulator over the terms of the merger.

DWP and TPR should further consider how they can ease and speed up what should be a routine and beneficial commercial corporate action rather than treating it as a scheme failure which necessitates their intervention to protect members' interests.

Chapter 3: Contractual override without consent for contract-based arrangements

12. Under what circumstances should providers be able to transfer savers to a new arrangement without their consent?

We are supportive of the principle of transfers out of contract-based schemes without member consent, but the rationale for doing so must be carefully explained. One way of doing this would be to link such decisions to the outputs of the DC Value for Money Framework, subject to the current issues with the latter being addressed (as highlighted in Q8 above).

13. Do you think that an independent expert, such as an IGC, should be responsible for undertaking the assessment of whether a transfer is appropriate?

Giving an independent expert, such as an IGC, the responsibility for making an assessment of whether a transfer is appropriate could bring confidence to such a judgement and mitigates the conflict of interest faced by a provider to avoid making a negative assessment. One additional consideration here would be the possibility that the provider may need to indemnify the IGC/independent expert against potential legal liability arising from any decision related to without-consent transfers.

15. What, if any, role should the employer have in the transfer process?

17. What procedural safeguards would be needed to ensure that a new pension arrangement is suitable and in the best interests of members? What other parties should be involved and/or responsible for deciding the new arrangement?

<u>Combined answer to Qs 15 and 17</u>

While IGC/independent oversight provides a mechanism for an employee to be transferred out, it does not provide for the selection of a new scheme for the member to be transferred into. This is where the employer could play a useful role: by selecting a new scheme for their employees to be transferred into. This would complement the employer's existing duty under automatic enrolment. In the scheme selection process for transferred employees, employers could use the advice of Employee Benefit Consultants (EBCs) to inform their decision-making. Where it is current employees' previous pension arrangements that are deemed poor value, they could simply be transferred into the employer's current scheme.

26. What costs do you expect to be involved in a contractual override/bulk transfer and what factors may influence the level of costs?

While pension providers are best placed to opine on the level of costs directly associated with the bulk transfer, we note that members will incur transaction costs from divesting their investments from the old scheme as well as in re-investing the proceeds in their new scheme. These transaction costs will vary according to the asset classes held, size of the transfer and market conditions at the time of these transactions. In addition, as the government encourages DC schemes to invest in private markets, the additional time needed to sell less liquid, private assets, as well as the price impact, will need to be factored into the execution of the transaction.

Chapter 4: Costs versus Value – The role of employers and advisers

29. Do you think establishing a named executive with responsibility for retirement outcomes of staff could shift from the focus on cost and improve the quality of employer decision-making on pensions?

Ultimately the emphasis should be on pension providers to design high quality, well-diversified investment strategies that balance potential for good outcomes with an appropriate level of cost. However, given the provider-driven low-cost competitive dynamics in this market, there may be merit in giving employers a role in ensuring the scheme they have selected provides value for members on an ongoing basis. This would be more realistic than a giving a legal responsibility for staff retirement outcomes to a named senior executive. This is because retirement outcomes are driven by a number of factors beyond the scheme selection decision that are not all in control of a named executive. These are: contribution levels; investment returns; policy around tax incentives for retirement provision; and decisions around accessing retirement income. Making a named executive accountable for outcomes that are largely driven by factors beyond their control is not proportionate or feasible.

30. What evidence is there that placing a duty on employers to consider value would result in better member outcomes? If such a duty was introduced, what form should it take? Should it apply to a certain size of employer only? How can we ensure it is easier for employers to make value for money comparisons?

Evidence in this area is by definition lacking, as we are not aware of such an approach having been used previously in any workplace pension system. Furthermore, we are wary of employers, particularly smaller ones, being given a duty to assess value by considering factors in which they do not have expertise. A better approach would be to require employers to carry out a periodic review (e.g. triennially) of their pension arrangements to ensure they are providing value for members on an ongoing basis. In doing so they would draw upon the advice received from EBCs and Investment Consultants, which we recommend becomes regulated (see answers to Qs31 and 32). This would build on the existing Employer Duty under auto enrolment. Consultants in turn could be required to make use of the DC Value for Money Framework[6] in providing their advice to employers.

[6] Subject to the concerns we have highlighted with the current Framework proposals being addressed. See our answer to Q8 above.

31. What evidence is there that regulating the advice that some employers receive on pension selection will better enable them to consider overall value when selecting a scheme?

Since this kind of advice is not currently regulated, there is no evidence available on the impact it may have on scheme selection decisions. Anecdotally, it is well known that in the DC workplace market, charges tend to be the primary driver in the employer's scheme selection decision. The benefit of seeing scheme selection advice becoming regulated would lie in the regulator being able to assess the basis of advice given and set expectations around the factors that should be considered, as well as the weight given to them. For example, regulators could set out a view that charges should not be given undue weighting relative to other factors considered in scheme selection; direction could also be given as to use of the Value for Money Framework in the advice process. Importantly, being regulated means that advice can be assessed by the regulator ex-post to see if the market is moving away from a narrow focus on charges.

Many of the firms that provide scheme selection advice are already FCA-regulated for elements of their business. We therefore expect that they would be comfortable with an extension of FCA regulation to the elements of their business that are not currently regulated.

32. What evidence is there that regulating the advice that pension schemes receive on investment strategies would enable more productive asset allocation? What type of regulation would be effective?

We are not aware of evidence that would suggest that regulation of investment advice to pension schemes would lead to greater allocations to productive assets. Nonetheless, regulation more generally can have a significant impact on how schemes invest – e.g. the DB funding regime and the focus on liability management or the DC charge cap and the impact this has had in driving DC schemes to seek low-cost investment exposure.

We are broadly supportive of regulating advice on investment strategy and asset allocation, though care is needed as to how this is done: asset allocation represents the implementation of an overarching investment strategy that is specific to a scheme's investment goals. Any regulation in this area needs to avoid dictating to advisers and schemes what these asset allocation decisions should result in.

Nonetheless, the argument for regulation of investment advice to pension schemes is similar to the one for regulation of scheme selection advice: the need to reduce the primacy of charges in decision-making. Regulators could set expectations about the need for investment advice to consider value to the investor rather than purely charges, and direct advisors to ensure that charges are not over-weighted in the advice delivered. They could also require advice to include the risk-return impact on a portfolio of adding different asset classes. While such an exercise might seem quite basic, we understand that not all schemes conduct them, in part due to their cost - the lack of such analyses may inhibit allocation decisions. This may again be indicative of a narrow market focus on minimising costs.

Regulation of investment advice also means that regulators can assess advice to ensure that the relevant requirements are taken into account.

One radical option that could be considered would be to allow for a specified time period during which pension providers could increase the expected risk/return of the default option and raise charges to members (within the charge cap) without needing client approval. Providers often face challenges in increasing charges due to the need for client or member agreement. By working with regulators, providers could demonstrate plans to enhance expected returns by x%, justifying a corresponding increase in charges.

The challenge with such an approach is that depending on the investment cycle of a given asset class or sub class, it may be difficult to define an appropriate period or, indeed, market conditions outside the control of the provider may not deliver as expected.

However, this does illustrate the importance of considering more radical solutions to change a prevailing culture that, despite good intentions in the policy and regulatory process, has resulted in investment being consistently under-weighted as a priority through the rollout of automatic enrolment.