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The Pensions Investment Review Call for Evidence Team
HM Treasury

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Dear Pensions Investment Review Team,

LCP's response to the Call for Evidence on Pensions Investments

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,000 people in the UK, including 160 partners and over 300 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 80% of our work is advising trustees and employers on all aspects of their pension arrangements, whether DB or DC, including investment strategy. The remaining 20% relates to insurance consulting, energy, health and business analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Introduction

We welcome the opportunity to comment on this important Call for Evidence on Pensions Investments. The Call for Evidence asks questions about both DC and LGPS aspects of investments, however, we have only answered about the DC aspects. We advise on over £60bn of DC assets across a variety of DC schemes from Master Trusts to GPPs and Single Employer Trusts.

Whilst we answer your specific questions below, we have taken the opportunity to summarise our key messages, for your convenience:

- We are supportive of consolidation, where it is in the interests of the members. We note that this is already in train across the DC market. We are **cautious of an overly consolidated market** – particularly at the pension provider level – that reduces competition and innovation, given the consolidation generally means to the commercial Master Trust market. This may also have risks that the remaining providers become "too large to fail" creating moral hazard and ultimately risks for the taxpayer. So, while we are supportive, we're asking that consolidation is progressed with caution.
- The majority of UK DC schemes use a small number of financial services firms to provide access to a much wider range of investment funds and managers. These pension providers also offer many of the Master Trusts available in the market. **If these firms were incentivised to make investment products that provide access to UK private markets – such as Long Term Asset Funds ("LTAFs") – more readily available, significant capital could be deployed more quickly and relatively easily.** We have examples of many clients who would like to invest in private market funds, but they are not available from their pension provider.
- There are **examples in our industry where policy has driven changes in behaviour in DC investment strategy design** without going as far as mandating investment – for example, climate risk and environmental, social and governance ("ESG") integration. Our view is that the success of these is largely due to the need for trustees to consider these factors in their choice of investments, which has required advisers and industry more generally to increase their support to trustees in these areas, for example, expanding their research to cover ESG product ranges. We view this approach as one that could be followed for UK productive investments, requiring trustees to have formally assessed UK opportunities against global market alternatives before investing their members' savings in key asset classes, such as private and real assets.

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- **We believe there is a need to improve the view of the attractiveness of investing in the UK.** Removing barriers to investing in UK productive assets, as discussed elsewhere in our response, is important but may not be sufficient on its own. DC investors must also believe that UK assets are at least as attractive as overseas assets from a financial perspective. Initiatives such as LIFTS have highlighted an opportunity for one sector, and expanding this approach to incentivise investment into other sectors and potentially regional investment would provide greater access and insight into what the UK can offer investors – alongside a co-investor.
- The progress made to date by UK DC schemes in the broader area of private markets is due to the relaxation of rules; guidance from government and regulators; and targeted support through initiatives such as the new LTAF authorisation process. However, we believe further support could be offered which would ease investment and therefore accelerate the take-up of private market and productive assets. For example, the vast majority of the private market industry still remains off limits to UK DC given the structures and the limited range of LTAF authorised investments. We agree with the BVCA's recommendation[1] that the **FCA should further review and amend the permitted links rules** to either exclude default investment strategies from the permitted links rules or to add further common private capital fund structures explicitly as a conditional permitted link.

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?

Firstly, we need to be clear what "more consolidated" means. Some commentators have expressed views that there should be as few as five or six Master Trusts operating in the UK market. Our view is that this is a dangerous level of consolidation and insufficient for healthy competition which could prohibit any future new entrants entering the market and further, limit future innovation. Our view is that there should be several times this number of large schemes encouraged to support UK DC pension savers. We note that it has recently been reported[2] that there are more than 60 MySuper products in Australia; a market that is regularly cited as consolidated.

Advantages

Covering the advantages of consolidation first, these are likely to include economies of scale for better cost efficiency; greater efficiency in shepherding the allocation of private capital in larger lot sizes; and, possibly, a higher appetite to include private markets in portfolios by the schemes (although we are already seeing many Single Employer Trusts make allocations).

Consolidation should also lead to regulators such as the FCA and TPR being able to focus more successfully on a smaller number of larger schemes and this could lead to improved regulatory oversight.

Disadvantages

The risks of consolidation include the concentration of risk in much larger commercial Master Trusts which become "too big to fail". This point was raised in the review of Master Trust regulation carried out by the DWP in November 2023[3] and is illustrated by various sources of evidence such as our own research and public information available from Go Pensions' Master Trust league table[4] which demonstrates that 87% of funds under management in the commercial UK Master Trust market is held by just 10 providers (out of 21 - including Nest) and that 68% is held by the 5 biggest providers (including Nest). So, whilst consolidation can lead to improved regulatory focus on each provider, the impact of a failure by any one of them becomes that much greater and potentially significantly more damaging to the industry as a whole.

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[1] BVCA Pensions & Private Capital Expert Panel - Interim Report – September 2024
[2] Super Statistics - ASFA The Voice of Superannuation since 1962
[3] Evolving the regulatory approach to master trusts - GOV.UK (www.gov.uk)
[4] DC Master Trust League Table 2023 ~ H2 – Go Pensions (go-group.co.uk)

From a member's perspective, many employers of Single Employer Trusts subsidise pension costs, however, moves to Master Trusts are often made to shift these costs to savers. This has led to cost-driven selections of Master Trusts, focusing on lower costs and charges to lessen the impact of this cost transfer. Consequently, simple passive strategies have dominated Master Trust investment strategy design to meet the specific selection requirements, limiting potential for better outcomes.

Another risk of consolidation is that there could be less of an incentive for providers to innovate for new business – as innovation could be perceived as risky – with a result that every offering could end up looking very similar. We believe there needs to be a clear balance between efficiency improvements gained through consolidation versus competition and choice which could drive forward innovation.

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

The Single Employer Trust market is hugely varied. At the larger end of the scale we see well governed Single Employer Trusts, with a fully committed sponsor, that provide their members with value and good outcomes comparable to any arrangement in the market, including Master Trusts. We believe these should be encouraged and continue to exist in the future DC market. It should also be noted that many arrangements contain legacy guarantees and provision complexities which are not possible to replicate through consolidation.

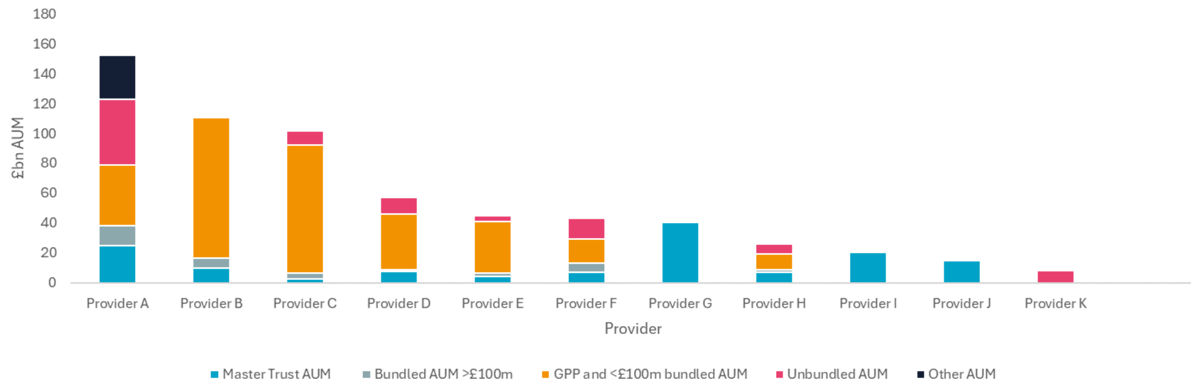
We also believe it noteworthy that several of these Single Employer Trusts, including those we advise, have been keen to invest in illiquid assets to benefit their members – and have already invested in these assets, more quickly than most Master Trusts[5] and to a higher level of allocation. Since Single Employer Trusts do not have the same commercial considerations and constraints as Master Trusts, which provides freedom to explore and innovate new investment solutions without the cost restrictions a commercial offering can bring.

We also believe there needs to be clarity on the purpose of the drive for consolidation. If the intention is to enable a small number of large DC schemes to make more direct investments in UK asset classes such as unlisted equity and infrastructure then consolidation of small schemes will have little impact on the scale of the large DC schemes and Master Trusts. Conversely, if the drive for consolidation is to reduce the overall number of DC schemes that need regulation then this requires different measures and should be stated.

Across LCP's Single Employer Trust clients, it should be noted that **all of these DC pension arrangements already use a provider through which they access their investments** – either through a bundled provision (where the provider offers both administration and investment services, either contract-based or trust-based) or on an unbundled basis (typically referred to as an investment only platform). This includes many of the largest Single Employer Trusts in the UK market. The effect of consolidation for these clients would simply involve switching products with providers, rather than increasing overall provider AUM, as shown in the chart below. The market is already consolidated by number of providers, and we'd be happy to provide further information if useful.

[5] HSBC scheme launches LTAF as it adds private markets to DC default | News | IPE

Chart 2.1: Size and product split across key pension providers and Master Trusts.



Source: UK Pension Providers and LCP research

The fundamental issue for many Single Employer Trusts is that private market and productive assets are out of reach, given their current investment platform or provider does not offer access to any investments in these asset classes. That includes both larger and smaller schemes. We believe there needs to be a clear message to UK DC providers or some sort of incentivisation offered to broaden the choice available to UK pension scheme investment, which would speed up investment for members, rather than requiring schemes to consider switching platforms or providers, or eventually to consolidate into a Master Trust which is a process that can take years.

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?

Firstly, there needs to be clarity on what is deemed “UK productive assets”. This will focus pension scheme attention on what the government is trying to achieve. We would also note that many Master Trusts and large Single Employer Trusts are investing now in illiquid assets. If these assets do not meet the government’s definition it would be hard to reallocate this capital.

Thinking about the future DC landscape, while products can look similar across trust and GPP markets, there is greater interest in the Master Trust market from employers and trustees and hence, where we see most growth in the future. The reason for this is not due to any clear product differentiation but due to the ease of transfer of benefits from existing own trust or legacy own trust-based schemes and the greater level of flexibility afforded to trustees of their arrangements rather than through individual saver contracts with providers.

Trustees are more likely to be involved in the design and agreeing a new investment strategy compared to an IGC, whose role is focussed on pure governance and oversight. Hence, we view Master Trust trustees as having a closer link to the development of default investment strategies, helping to drive innovation and change.

When it comes to adopting new investment strategies, it should be noted that many providers look to develop the same main default investment strategy for both their GPP and Master Trust offerings (including if that strategy invests in illiquid assets or UK productive assets). However, in our experience, GPPs tend to have more practical problems implementing new strategies than Master Trusts. This is largely because GPPs can have issues with individual contracts with savers which can mean members cannot be moved into these new strategies. These individual contracts are harder to modernise – whereas Master Trusts tend to have less historic “baggage”.

We believe that the trustee board of a Master Trust is more likely, and will find it easier, to adopt new investment strategies that include more sophisticated investments such as private markets and productive assets than GPPs – again the problem of individual contracts with their savers can limit the appetite and ability of GPPs to change investment strategy.

Recent examples of challenges GPPs have faced when trying to improve outcomes for their savers include:

- Only 50-80% uptake by savers, given the changes required saver consent
- A provider highlighted that the cost of mailing updated investment terms and conditions to all GPP members would be prohibitively expensive

For GPPs, the contractual limitations which has created significant legacy business does provide a key consolidation opportunity. As such, we believe providers should be more supported through legislation to enable consolidation of default and investment strategies across their legacy books of business with the oversight of their Independence Governance Committees.

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

As we allude to above, one major barrier to consolidation in the GPP space is the issue of transfers without consent – you will be aware that the FCA has addressed this in their current VFM consultation[6] and therefore we refer you to their own analysis of this issue.

Turning to Single Employer Trusts consolidating to Master Trusts, one perennial issue that has not been solved despite being highlighted for several years is where Single Employer Trust schemes have guaranteed benefits such as guarantees, underpins or other benefit complexities. It still remains difficult to transfer these to a Master Trust.

More broadly, any transfer of benefits these days has to include consideration of pensions tax law issues such as protected PCLS and protected pension ages. These considerations can currently cause significant problems, delays and costs when carrying out bulk transfer or consolidation exercises. We suggest that government should be mindful of these issues when attempting to drive consolidation forward.

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?

As we are restricting our answers to DC matters, we are making no comment about this.

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?

The reality of the current commercial market is that costs and charges to savers dominate the competition for new business by providers. This is because when employers move their pension provision from their own Single Employer Trust to a commercial Master Trust this usually involves a transfer of costs from the employer to the savers. Hence, to minimise this impact, employers tend to focus on driving down the costs they are passing onto their employees beyond all other factors. We have heard from providers who offer quality services that they can still lose new business just because of a single basis point difference in price.

[6] CP24/16: The Value for Money Framework | FCA

It is therefore understandable that providers drive down their own costs and reduce service and innovation when there is no new business “reward” for investing in these areas or for setting a more sophisticated asset allocation if those investments are more expensive. We are seeing improvements in this area, through initiatives such as the work undertaken by the PFWG[7], however, still see a focus on ‘saving employer costs’ as a pitch strategy to undertake Master Trust selections for corporates by advisors.

Again, we note that the FCA has a current consultation about VFM and many of the points raised in that are relevant to this question. We believe that splitting out costs to be clear what each product costs for investment and admin and removing a single view of costs (typically referred to as bundled pricing) could help with this – as passing on the administration costs from corporates to members without being transparent about this would then not be possible.

We are also very aware that not all employers receive advice on the selection of a Master Trust. We highlight our views on this in the next question.

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?

Employers

There are two important markets when considering employer involvement – advised and non-advised. While those employers who seek advice are likely to see some sort of framework akin to assessing value for money as part of their advice, even taking account of our comments in the previous question, it is difficult to assess the decision-making process of employers where advice is not sought.

We view the lack of any requirements on employers to either receive advice or to make a decision on their chosen pension arrangement according to a specific framework as an inconsistent part of the decision-making process which can impact on member outcomes.

We believe employers should be required and supported in assessing providers and provider offerings against an overriding objective of focusing on member outcomes and not on costs, with costs being split out both at selection stage and in employee consultations as investment costs and wider costs (eg administration etc).

Provider/platform market

As we have noted already, we do view the lack of access to both government backed initiatives and LTAF launches aimed at the DC pension market as a market failure. We view the incentivisation of the provider and platform market to make these investments available to their client base would significantly speed up access by existing schemes without requiring consolidation.

Safe harbour

We do view the opportunity of a safe harbour provision around default investment choices as a potentially supportive government intervention, which would afford employers and trustees more comfort when considering the design or selection of a default investment strategy.

[7] Investing in Less Liquid Assets – Key Considerations, Productive Finance Working Group

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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?

(Our answer to this question relates to the workplace DC market, not the LPGS.)

In our experience, Single Employer Trusts and non-commercial Master Trusts already have focus on net investment returns and member outcomes rather than simple costs as they, unlike commercial Master Trusts, do not have to compete for business.

In a highly consolidated competitive Master Trust market, there is likely to be greater focus on details areas such as costs and charges and little flexibility across offerings.

Addressing the question more directly, diversification considerations mean that scheme portfolios are generally invested on a global basis. A more consolidated DC market is likely to lead to more investment in asset classes such as unlisted equity and infrastructure, however, we believe this is currently a low priority due to its longer lead time, the cost pressure and regulation issues. If the cost pressure stopped tomorrow, investments in more expensive assets could increase significantly for commercial vehicles.

Our second point relates to the current availability of suitable investments. Access to private markets in DC has moved forward with the LTAF authorisation process. However, the market remains fairly limited in terms of the range of LTAF choices and as such, we believe incentives to broaden choices would be helpful for the market more generally.

We would also note that investment in unlisted equity and infrastructure will continue to be focused at a global level. As a corollary this may well increase investment in these assets in the UK but in percentage terms this will only be a marginal increase – albeit in absolute terms that could still be a significant amount of money. But the point is that professional trustees consider investment on a global basis in the context of their fiduciary duties to their members rather than any political agendas which are not legally binding. So, in simple terms, the way to increase investment in the UK is for UK assets to offer better return opportunities than the rest of the world, or for incentives to be offered to encourage increased investment.

We also believe that there may be a misunderstanding about the impact that increased investment in UK-**listed** equity would have on UK **growth**. Recent data over the last few years suggests that over four-fifths of the sales of FTSE 100 constituents comes from outside the UK. So there is not a clear correlation that increased investment In UK-listed equity will lead to an increase in growth in the UK economy.

Finally, we note that the FCA’s Consumer Duty requires firms to act to deliver good outcomes for retail customers. This could make it difficult for providers to over-allocate savers’ funds into the UK if it appears objectively that better or even “as-good” returns can be obtained elsewhere.

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?

In our experience major decisions about pension fund investments are usually based on very long-term strategic return forecasts. Views on short or medium-term (<5 years) asset returns generally only result in small changes in asset allocation and it is not usual for schemes to change asset class allocation relatively frequently, eg annually.

One of the main drivers of the reduction in UK asset allocation over the past 20 years has been a desire to increase diversification and reduce risk through investing in more market-cap weighted investments ie reduce biases and over/under weight allocations. Given the UK has a small weighting in market-cap indices, pension scheme investment has therefore reduced over time. This has benefited members and the value of their savings over recent years as the UK equity market has generally provided lower returns than global markets.

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 PLSA recently wrote a report titled Pensions & Growth: Creating A Pipeline Of Investable UK Opportunities. Overall, we support the conclusions of this report.

However, we would caution against any change in the "social contract" for individual pension savings. For a long-time this has been understood to be "*you receive tax incentives to provide for your own retirement so that you are not as reliant on the State in old age*". We would be disappointed if this were to change to "*if you receive tax incentives for your own pension provision then we expect you to invest your pension in the UK*".

Notwithstanding the previous point, there remains the current barrier that schemes have difficulty investing in UK productive assets, even if they want to, due an inability or unwillingness by platforms and providers to offer suitable funds. Incentives – rather than compulsion – could be used to make these investments available to more schemes which could significantly improve potential for future investment.

One additional incentive that could be considered is the removal of stamp duty from UK equity dealings. Although this may not make a material difference it would be a further reason for buyers to choose UK equities over international equities.

This in turn raises a key overriding theme that the UK government needs to improve the view of the attractiveness of investing in the UK. Removing barriers to investing in UK productive assets, as discussed elsewhere in our response, is important but may not be sufficient on its own. DC investors must also believe that UK assets are at least as attractive as overseas assets from a financial perspective. We would like to see government sponsoring more co-investment opportunities – similar to LIFTS – but in other areas of potential growth and opportunity. These could include regional or sector opportunities to encourage innovation, which could be sponsored and supported by the wider UK Growth Fund initiative. This would provide greater access and insight into what the UK can offer investors and offset concerns with establishing investment in these new opportunities.

As an example, we have called[8] on Government to set clear, credible, consistent net zero plans which are nature-friendly and socially-just so investors can invest in the net zero transition with confidence. This ask has already received endorsement from 41 asset owners with assets totalling £182 billion[9]. We believe clear net zero pathways for key sectors of the UK economy would increase the attractiveness of UK productive assets for DC investors.

And it should go without saying that any additional incentives should, at the least, encourage investments that lead to positive outcomes for environmental and social systems, due to their importance for the long-term health of the UK economy. As part of this, the fiduciary duty of trustees could be clarified so that environmental and social outcomes can be more readily taken into account.

We hope our comments are useful. We would be very happy to discuss any of them further with you if that would be helpful.

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[8] Pension schemes totalling £84 billion back LCP's call for policy changes to combat climate change.

[9] Data at 25 September 2024.

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Yours sincerely

{By email only 25 September 2024}

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