CMIT

Pensions Investment Review: Call for Evidence

Capital Markets Industry Taskforce response

Dear Minister,

It was an honour to welcome you to the CMIT conference last month, and to host your inaugural Ministerial speech. We would like to thank you and your team for what has already been a very active, expeditious and constructive approach to engaging on your review.

Your review is crucial to unlock what we believe is the untapped potential of the UK's pension system to deliver dignity and security for savers in retirement and drive sustainable growth in the UK economy.

About CMIT

As you know, the UK Capital Markets Industry Taskforce (CMIT) comprises CEOs, Chairs and industry leaders representing private and publicly listed companies, asset owners and managers, and the advisory services that support their access to capital and investments – representing the full end-to-end ecosystem of the public and private capital markets.

The Taskforce aims to maximise the impact of capital market reforms, ensuring the UK is the place where great companies can start, grow, scale and stay and to help investors access assets that provide returns and support the real economy in which they live and work.

Introduction

CMIT is delighted to respond to the Government's Pensions Investment Review.

Launched at our conference, CMIT has supported two important reports, which we hope will help inform industry, regulators and policymakers as we think collectively about how best to equip our capital market ecosystem in the future. The Capital Markets of Tomorrow report , led by Sir Nigel Wilson, sets out how to ensure the UK remains a leading global financial centre that can support the growth of the UK economy, and the New Financial report Comparing the asset allocation of global pension systems, sets out how the UK invests its pensions capital compared with other developed markets.

The status quo in the current UK pensions system is clear. UK pension funds:

1. Underinvest in UK capital markets
2. Underinvest in productive assets
3. Are the most fragmented in the developed world.

CMIT is unanimous in its belief that these outcomes must change and wants to support the government in creating a better policy environment, which ensures capital can better deliver for pension savers, and the country. We believe time is of the essence and encourage you to keep up the pace with which you have begun this important work,

At the CMIT conference on 6 September, Sir Nicholas Lyons and Peter Harrison conducted a workshop with senior industry stakeholders on 'unlocking capital' from pensions. We used this session to seek views from a wide range of participants, which have informed this submission.

You will no doubt receive a large number of detailed responses from a wide range of market participants – and individual CMIT members will be making their own submissions. As a result, we have not answered every question in the call for evidence in this submission, instead focusing on the subset of issues that, as a group, we think are the most important:

- The urgent need to consolidate the DC market.
- The importance of shifting the focus of that market to the creation of long-term value, not just the minimisation of costs.
- A similarly important need to restructure the LGPS sector.
- The case for investment in the UK.

We believe employers have a crucial role to play. As the link between savers and providers, they can help to unlock the potential of more progressive asset allocations to deliver better outcomes for their employees, and for the country.

As always CMIT and its members would be very happy to discuss these issues in more detail with you and your team.

Yours sincerely

Dame Julia Hoggett

CEO of the London Stock Exchange and CMIT Chair

Sir Nicholas Lyons

Chair of Phoenix

Peter Harrison

Group CEO of Schroders

Sir Jon Symmonds

Chair of GSK

Joe Cassidy

Partner and UK Head of Technology, Media & Telecoms at KPMG

Mark Austin

Partner Latham & Watkins

Matthew Scullion

CEO of Matillion

On behalf of the Capital Markets Industry Taskforce with one member recusing themselves.

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?

A much more consolidated DC market will better serve savers and the wider UK economy.

Larger schemes benefit from economies of scale in their administration and can develop the investment capabilities to engage in more diverse asset allocations, with the scale of assets to facilitate this (e.g. more meaningful allocations to private markets or less liquid asset classes).

The DC market is estimated to reach £1tn of assets by 2030. We should re-assess how we think about "scale" in this context, as even schemes reaching £50bn of assets (with many currently well short of this mark) implies 20 or more providers in the market.

During the CMIT conference workshop, there was strong support for consolidation and bold action that enables the market to respond efficiently. In this vein, we fully support the intention of the FCA's recent Value for Money proposals, and the clear commitment from the Pensions Regulator to replicate the final rules across the market. Aside from being at the heart of shifting the market to genuinely compete in the long-term interests of savers, we think the proposals will be a powerful tool in consolidating DC schemes into a smaller number of ever larger, better performing schemes. It will be important that both regulators have the resources necessary to supervise the new regime actively, starting with the smallest, least performing schemes (where there is the greatest risk of harm to savers).

In the long-term, we should be mindful of the normal risks that can occur when markets are highly concentrated. Once the DC market reaches a small number of very large players a lack of competitive pressure could reduce the incentives for providers to complete on things like quality, instead focusing on running the most cost-efficient operations possible. However, given quite how fragmented the UK landscape is at present, we believe we are a very long way from these risks crystalising in practice, and measures like Value for Money are being implemented already to help pre-empt some of these risks.

We think the Government and regulators should feel confident to press on at pace to consolidate the market, with time to consider possible competition issues down the line.

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?

If the Government's aim is to seek the investment performance that best secures the members' benefits, and to use public sector asset pools to invest in the fabric of the UK, then we should move beyond the current system. The aim should be to transition to a single, or small number of fund(s) overseen by a smaller team of investment professionals. These people should be paid competitively to attract the right talent and experience, and they should oversee progressive asset allocations that target long-term value creation for members, through a mix of in-house investment expertise, and third-party specialists.

We agree that a portion of these asset pools should be directed to investment in the UK (broadly defined) and that this argument is particularly strong for LGPS given the implicit Government underpin for the schemes. Financial returns of course matter, but we think there are good arguments for the broader impact productive investment into public and private markets has on the economy and society that pensioners retire into, supporting the case for UK investment.

Local political interests naturally make the potential for conflicts of interest more acute in this model, so strong, independent investment governance will be required to manage this. It is right for Government to set out high level mandates for these pools, but managers should be left to manage to these independently.

We recognise the political and operational challenges of such a transition. In an inherently political system there are inevitably vested interests that support the status quo. These are understandable. But we believe these challenges have been well-understood for some time. The question is whether, collectively, we wish to address them, or continue to operate within the constraints they impose given the inherently political nature of the LGPS system.

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?

CMIT notes that a focus on value over cost, and net returns to the savers, was the least contentious and most supported topic discussed at the workshop.

We believe this process starts when an employer decides to move from a single employer trust to a Master Trust. Generally, corporates seek advice on this, but this is a purely commercial relationship. Neither the employer nor the advisor has any legal duty to consider the long-term value created for the underlying beneficiaries as part of the transaction.

Clearly employers have some natural incentives to consider their employees' interests, but there is no formal duty, and there is normally a cost saving in outsourcing (as corporates normally stop paying administration costs post-outsourcing)

Master Trusts have strong, enduring incentives to seek scale in a high volume, low margin business. This has led to intense pressure to compete through low cost "all in" propositions (e.g. covering the transition costs of transactions for corporates). This is leading to ever lower fee budgets. The charge cap is 75bps, but we increasingly see "all in" budgets for these transactions of under 20bps, with sometimes 5bps or less allocated to investment.

Once outsourced, Master Trust Trustees have clear legal duties to act in the best interest of beneficiaries, and the advice they receive from consultants is grounded in these duties. But the space to discharge them is constrained by the budgets they inherit. Trustees may feel low investment budgets are inhibiting their ability to deliver for members, but we do not think it is realistic to expect them to 'refuse' prospective transactions on this basis as there are strong incentives for their competitors to accept this business in such a competitive market. Master Trusts are commercial organisations, and we should expect them to act rationally in the face of competition.

The advice consultants provide employers reflects this reality – they are right when they advise a corporate that the prevailing market price for a prospective transaction is under 20bps. The problem is that the advice is not required to consider, nor is the employer, whether this market reality is in the long-term interests of pension savers.

These constraints are driving a low-cost, largely passive approach to investment where it is more difficult to allocate to alternative asset classes. The new Value for Money framework, and increased transparency on asset allocations will be powerful tools in helping to move the market to compete on long-term value creation, not just cost. But they will not address the factors driving price competition from the original outsourcing decisions.

We believe to truly move the basis of competition in the DC market interventions are required that ground the initial outsourcing decisions of corporates, and the advice that drives these, in long-term value creation for members (of which cost is an important, but not sole factor).

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?

Following on from our previous answer – 'yes'. We believe a balanced strategic asset allocation is in the best long-term interests of pension savers and should include allocations to alternative asset classes like private markets and infrastructure.

This requires an investment budget capable of accommodating this. The imposition of the charge cap has helped to bring down the costs of pension scheme investment, generating savings for members. But we think it is now widely acknowledged that this dynamic has gone too far, with ever lower budgets "hollowing out" the investment proposition, restricting the scope to deliver long-term value for pension savers. CMIT believes that investment budgets need to grow modestly and that this will enhance, not reduce, value for members (and we note that the current price point is dramatically lower than the charge gap, indicating ample room for manoeuvre before pensions investment can be considered "expensive").

The initial decisions by employers when they outsource set the tone and the budget for the rest of the market. We think consideration should be given to interventions that place formal duties on employers, and/or their advisors, that decisions to outsource from single employer trusts must be grounded in delivering long-term value for members. This will mirror and support the existing duties on Trustees which will be strengthened further through the Value for Money framework.

We also think the Government should consider introducing financial incentives for schemes to invest in productive asset classes. Consciously changing the return profile of certain asset classes would create natural incentives for asset allocations to change, and prompt conversations with providers on how these can be accommodated within investment budgets for both existing and prospective transactions.

While DB pensions are outside of your review, we support further work to consider how corporates access surpluses in DB schemes safely. Insurance buy-out will remain a fundamental part of this market and the gold standard of securing member benefits. However, allowing easier access to surpluses – sensibly governed to maintain appropriate protection for scheme members – would provide an incentive for some corporates, where appropriate, to "run their scheme on", rather than go to buy-out, enabling a "re-risking" of a portion of corporate DB. Not only could this meaningful increase productive investment, but it could also provide a direct injection of capital to UK corporates to innovate and grow.

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?

Data from New Financial makes clear that there is ample scope for LGPS and DC workplace pensions to invest more in the UK.

Their report makes clear that UK pension funds could increase their allocation to UK listed equities by 50% to 100%, adding roughly £50bn to £100bn in investment, and still be well within international norms.

Crucially, the increased flow would enhance UK capital markets attractiveness. We know that the depth of the capital pool is one of the most compelling features for where businesses choose to locate. We see the Mansion House Compact as providing capital for growth firms, who wish to one day list on the UK market. We should not therefore seek to narrow the definition of a firm already listed in the UK, as any international constituents contribute to the aggregate size, and, therefore, strength of the market.

Particularly striking is that workplace DC pensions in the UK allocate on average only 2% to unlisted equity (anywhere, not just in the UK). This is less than half the allocation from UK DB (around 5%). This makes no sense given the liability matching nature of DB compared with the returns generating aim of DC. We believe this reinforces that price competition, and operational factors like the focus on daily liquidity on platforms used by DC pensions to facilitate investment, are inhibiting investment in unlisted equity in the UK and elsewhere. International comparisons suggest this is to the detriment of long-term returns for savers.

The Mansion House Compact, and initiatives like the launch of Future Growth Capital, are important market-led efforts to change this. These will be reinforced by the new Value for Money Framework and greater transparency on pension scheme asset allocation.

Again, we recognise that DB pensions are outside the scope of this review, but they remain an important part of the pensions' investment landscape and will be for years to come. As DB schemes are insured, or 'bought out', they are governed by the Solvency II regime, and CMIT recognises the significant effort that has gone into reforming this framework from insurers and the PRA. These reforms have made some progress, but we are of the view that they have missed an opportunity to make a bigger impact on productive UK investment without exposing DB beneficiaries to undue risks. For example, we think the revised rules disincentivise investment into new infrastructure (and with many DB schemes wanting to be "buy out ready" these disincentives stretch far beyond just insurers) where DB schemes should be natural buyers for UK infrastructure. CMIT supports Phoenix's suggestion of a "sandbox" to move this debate on constructively.

Greater investment from domestic pension schemes into UK listed and unlisted equity, and infrastructure, should directly and indirectly drive growth in the UK. It will support more companies to start, grow, scale and stay in the UK contributing directly to employment, exports and tax receipts. Investment in infrastructure provides well documented network effects that support economic growth. Creating more natural and consistent demand for UK assets from UK buyers can only be beneficial for UK Plc.

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?

CMIT believes there are good arguments that pensions investment is about more than financial purism. As heavily tax subsidised capital pools it is sensible to see UK pensions as having a role investing in the country that is generating that tax subsidy and which savers will retire into. The economy, infrastructure and society in the UK have as much of a bearing on savers' quality of life in retirement, if not more, than the raw financial power of their pension savings.

The question is what role Government policy should play in incentivising or requiring investment in the UK. We think it is better to use incentives (or disincentives) to change the return profile of different asset classes and allow investors to respond accordingly, than it is to 'force' investment into specific areas. This has clearly worked in e.g. the Australian market.

Ideally the UK would introduce new incentives to encourage investment into sectors consistent with the Government's Missions. If the fiscal position does not allow for this, we think it is reasonable to consider the existing framework of pensions tax incentives and whether a portion of this might be made contingent on certain minimum allocations to specified UK investments. We think there is a clear democratic logic to this argument.

From an investment perspective if incentives or requirements are too narrow this risks channelling too much capital into too few investments, distorting prices. To avoid this, we think "the UK" should be defined broadly encompassing infrastructure that is physically here, private companies registered here, public companies listed on UK regulated markets and funds with a clear UK focus. This retains space for investment managers to seek the best investment opportunities within a broad framework.

If disincentives or requirements are implemented too quickly this will be disruptive, so we think any transitional period should be significant.

The above principles should also apply to encouraging or requiring local investment, including by local government pension schemes. Strong governance will be particularly important when considering local investment. There will be clear political incentives to direct local investment and independent investment governance will be required to manage these inevitable conflicts.

We believe clear incentives (or requirements) are preferable to 'comply or explain' approaches, which introduce inevitable tension with trustees' fiduciary duties. This is not about the drafting or interpretation of the duties (which we think is broad); it is the practical matter that trustees will have arrived at an asset allocation they believe is consistent with their duties. If this differs from new targets, then trustees will be caught in an understandable tension between what they think the "right answer" is, and the clear intent of policymakers. There is a risk we essentially ask trustees or elected members to think something that they did not think last month, introducing understandable tension. Incentives or requirements that provide a clear financial or legal justification for change would address this problem.

Data will be fundamental to ensuring this debate is grounded in facts and we support the increased transparency being implemented around schemes allocations to UK investments.

We recognise that consideration of a formal requirement for UK pensions to invest a certain percentage of their assets into the UK is controversial. But if the Government is considering such a step, we believe it is important for the market to take that seriously and engage in the debate about how that might be done in an effective way. Attendees at the CMIT conference workshop were not, in general, opposed to the principle that UK pensions should invest more in the UK, with many open to this being a formal requirement (if implemented carefully).

If the Government is minded to implement a legal requirement for certain schemes to invest a certain amount in the UK we believe the principles discussed above are crucial, that is:

- Define the "UK" broadly, and in ways that are clear and easy for pension funds and their managers and advisors to ascertain (i.e. it should be unambiguous whether a possible investment "counts").

- Define the general mandate – but be clear in principle and in practice that schemes and their managers are free to invest as they see fit, within the broad mandate that has been set.
- Provide a meaningful transition period.
- Make clear that meeting the requirement is unambiguously consistent with the fiduciary duties of trustees or elected members overseeing pensions.

The debate about requirements or “mandates” is often oversimplified and presented as a backward-looking comparison of, for example, returns on the FTSE 100 versus the MSCI Global Index or the S&P 500. This does the debate a disservice – no one is arguing for such a narrow mandate. CMIT wants managers and trustees to retain the large degree of freedom they need to make rational economic choices when investing on behalf of the saver.

We need an informed discussion of the merits and risks of our vast pension assets making a more meaningful contribution across UK investment opportunities. CMIT believes the economic, public policy and democratic case for this is strong. New Financial has shown that, far from our competitors adopting a financially purist approach, many favour their domestic markets in one way or another. We must recognise that failing to do so is a choice, and a choice that is depriving our economy of investment.

CMIT looks forward to being an active participant in this debate, and an advocate for change.