Pensions Investment Review: Unlocking the UK pensions market for growth

1 Response

1.1 This is the Pensions Policy Institute's (PPI) submission to the Department for Work and Pensions and HM Treasury's call for evidence on 'Pensions Investment Review: Unlocking the UK pensions market for growth'.

1.2 The PPI promotes the study of pensions and other provision for retirement and old age. The PPI is unique as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help decision-makers to take informed policy decisions on pensions and retirement provision.

1.3 This submission does not address all of the specific questions in the call for evidence, neither does it seek to make policy recommendations. Rather, the response summarises relevant conclusions and analysis from research that the PPI has conducted in recent years:

- 2020. ***Financial sustainability of master trust pension schemes.*** Available at: pensionspolicyinstitute.org.uk/research-library/research-reports/2020/2020-08-27-financial-sustainability-of-master-trust-pension-schemes/
- 2024. ***Pension scheme assets – how they are invested and how and why they change over time.*** Available at: pensionspolicyinstitute.org.uk/research-library/research-reports/2024/pension-scheme-assets-how-they-are-invested-and-how-and-why-they-change-over-time/
- 2021. ***What can other countries teach the UK about measuring Value for Money in pension schemes?*** Available at: pensionspolicyinstitute.org.uk/research-library/research-reports/2021/2021-11-18-what-can-other-countries-teach-the-uk-about-measuring-value-for-money-in-pension-schemes

1.4 This covering letter sets out the main conclusions of these research reports as they relate to the consultation. Please read the reports for the underlying analysis.

1.5 We are happy to talk further about any of the research discussed in this response if it would be helpful for the consultation.

2 Relevant conclusions from: Financial sustainability of master trust pension schemes

2.1 ***Financial sustainability of master trust pension schemes*** (2020) examines the ways in which the costs faced, and income received, by automatic enrolment pension providers can affect their financial sustainability.

2.2 Automatic enrolment has led to a rapid increase in pension savers, with more than 10 million enrolled since its introduction in 2012. Master trusts have been created to meet this increased need for pension provision. Setting up a master trust is a capital-intensive venture, requiring professional advisors, systems for processing contributions, fund management, administration and marketing.

2.3 The greatest challenge to the financial sustainability of master trusts is the need to cover initial start-up and running costs until levels of membership and assets have grown sufficiently. The costs associated with setting up a new pension scheme, as well as ongoing running costs, can be challenging to cover in the early years of the scheme while pot sizes are small. In order to meet costs during the period before the scheme income is sufficient, the master trusts will rely on financial support from other sources. If initial capital is provided as a loan, then servicing of that loan through regular payments is required as set out in the terms of the loan and is a cost to the scheme. These repayment cashflows also need to be met from future charges, alongside the ongoing costs of the scheme.

2.4 Modelling from the PPI back in 2020 suggested that the master trust industry would be unlikely to achieve breakeven on costs until around 2025. Thereafter, the industry may generate annual profits which will accelerate as the funds under management grow.

2.5 The ongoing costs of the scheme are closely linked to the number of pension pots that the scheme is operating. If the scheme has a large number of pots, in particular inactive pots, which have less revenue growth potential, the scheme may wish to take some action to mitigate the admin cost of the pots. It may be the case that some of the pots belong to the same individual, matching the records and in some cases consolidating the deferred pots could reduce inefficiencies and costs of administration.

3 Relevant conclusions from: Pension scheme assets – how they are invested and how and why they change over time

3.1 ***Pension scheme assets – how they are invested and how and why they change over time*** (2024) aims to examine the amount and make-up of the assets used for pension fund investment in the UK.

3.2 Combining different and incomplete data sets, the PPI estimates that the assets of the UK pension sector ‘towards the end of 2023’ were valued at just under £3 trillion, with Defined Benefit (DB) representing 55% and Defined Contribution (DC) having topped £1 trillion. Taken overall, bonds represent the largest share of assets at 38%, followed by equities at 33%, private equities and alternatives3 at 10%, with cash and other (largely unclassified) investments making up the remaining 19%.

3.3 Using a definition of UK productive assets that includes listed equities, corporate bonds, private equity and alternatives, the PPI estimates that 18% of UK pension assets is invested in UK productive assets. Using a much narrower definition that extends only to private equity and alternatives, the share drops to 6%.

3.4 When it comes to investment in these assets, significant differences exist between different types of pension scheme:

- Private sector DB pensions are the biggest investors in UK productive assets by value (£250bn).
- Public sector DB schemes are the biggest investors in UK productive assets by proportion of funds (31%).
- DC arrangements invest less by value (£101bn) and proportion (19%).
- Annuity providers are major investors in UK corporate bonds (£90bn).

3.5 Headlines on pension asset allocation are driven largely by the shift away from equities to bonds among closed DB schemes. In fact, the UK is undergoing a structural shift which is reshaping asset allocation in different directions. Significant differences exist between closed and open DB schemes, with a narrower and largely liability or cashflow driven approach featuring in closed schemes, but a much more comprehensive, complex and more growth-driven approach in open DB schemes. DC scheme asset allocation, by contrast, has been shaped in part by the limits on charges, the relatively small scale of many schemes and the dominance of pooled funds rather than direct investments.

3.6 Although the high-level picture suggests a move away from equities and a move away from UK investments, it is evident that the shift is far more complex than these two high-level changes suggest. To understand the direction of travel in asset allocation, it is necessary to understand the drivers of change and the way in which they are affecting different parts of the UK pension sector.

4 Relevant conclusions from: What can other countries teach the UK about measuring Value for Money in pension schemes?

4.1 ***What can other countries teach the UK about measuring Value for Money in pension schemes?*** (2021) provides an international perspective to the current UK debate around the definition of Value for Money (VFM) in pensions. It reviews recent developments in five other countries: New Zealand; The Netherlands; Australia; Sweden; The US and considers how these might relate to a UK VFM framework.

4.2 There are a number of key messages from other countries that are relevant to UK Defined Contribution (DC) practice and policy:

- A clear statement of and a consensus around the outcomes sought in assessing VFM are a necessary precondition to effecting positive change in which outcomes are expressed from members’ viewpoints as things that they value.

- By setting clear, measurable and comparative standards and benchmarks for performance in the key areas of delivery – investment, administration, engagement – it is possible to drive a more effective tendering process for these services to secure VFM.
- Publicly available, consistent, robust and complete comparative data is a vital starting point for authoritative VFM assessments and broader market context. The evidence suggests that this requires a trusted regulatory framework to facilitate.
- There are barriers to members exercising informed choice and so where choice is provided it is unlikely to lead to good outcomes unless the choices available are carefully designed and edited. Close, active governance will be required to manage this process if good outcomes are to be achieved and maintained.
- Achieving scale has positive impacts on costs, but diminishing returns will set in. Large funds face new opportunities to achieve diversity in assets through unlisted or direct investments to secure consistent high returns. Evidence suggests that this will increase unit investment costs if these additional returns are to be accessed.
- Consistently positive real investment returns, within appropriate volatility parameters – both upper and lower – are the most significant driver of VFM in terms of net returns. But outcomes for savers in terms of meeting target income levels are most influenced ultimately by the level of contributions.

For further information or if you have any additional questions please contact:

John Adams
Senior Policy Analyst
Pensions Policy Institute
john@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk

About the Pensions Policy Institute

We have been at the forefront of shaping evidence-based pensions policy for over 20 years.

The PPI, established in 2001, is a not-for-profit educational research Institute. We are devoted to improving retirement outcomes. We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. Each research report combines experience with INDEPENDENCE to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **INDEPENDENCE** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.