Response from the Pensions Policy Institute
25/09/24

Pensions Policy Institute
PPI

Pension Investment Review: Call for Evidence

1. Response

1.1 This is the Pensions Policy Institute's (PPI) submission to the HM Treasury and DWP call for evidence for the Pensions Investment Review.

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 consultation, neither does it seek to make policy recommendations. Rather, the response points to research that the PPI has conducted in recent years providing evidence and analysis relevant to the consultation questions. We are happy to talk further about any of the research discussed in this response.

1.4 This submission draws on evidence from a number of PPI publications, including:

- DC scheme investment in illiquid and alternative assets (2019)
  https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2019/2019-03-25-dc-scheme-investment-in-illiquid-and-alternative-assets/
  This report explored the potential benefits associated with investing in illiquid and alternative assets, as well as the cost, operational, governance and regulatory barriers which prevent some DC schemes from exploring these investment options.
- What can other countries teach the UK about measuring Value for Money in pension schemes? (2021)
  https://www.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/
  This report examined international approaches to value for money and the lessons to be learned for the UK in design and implementation of the VFM framework and facilitation of a broader shift from absolute cost to value for members.
- Pension scheme assets – how they are invested and how and why they change over time (2024)
  https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2024/pension-scheme-assets-how-they-are-invested-and-how-and-why-they-change-over-time/

This report collated available data to assess the way in which UK pension scheme assets are invested, as well as how and why this has changed over time.

2. Scale and consolidation[1]

2.1 There has been considerable consolidation within the DC market, with the number of master trusts reducing and many employers moving from single-employer trusts to master trusts. Since 2012, the number of non-micro trusts has fallen by two-thirds from 3,660 to 1,220 in 2022.[2] The average size of trust-based schemes has risen from £6m to £117m over the same period. The average size of a master trust stood at £2.9bn at the end of 2022 and £8.8bn at the end of 2023, with the five largest reporting assets of £113bn.[3]

2.2 As DC arrangements grow in size, so their approach to investment becomes more sophisticated.

The very largest master trust, Nest, with £36bn of AUM at the end of 2023[4], has moved away from 100% pooled funds to a position where a significant proportion of their assets are managed on a segregated basis, giving them scope to invest in a broader range of asset classes. As more master trusts reach critical mass, asset classes may broaden out still further with more adopting a segregated approach. Consolidation in DC is expected to support and drive greater diversification of asset classes; with this may come some additional costs for members and increased demands on governance bodies to ensure that new asset classes are understood. Continuing to put member outcomes at the forefront of decisions will be essential.

3. Cost vs Value[5]

3.1 There are a number of key messages from other countries that are relevant to UK DC practice and policy on VfM:

- 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.

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[1] PPI (2024) Pension scheme assets – how they are invested and how and why they change over time
[2] TPR (2023) DC trust: scheme return data 2022 to 2023
[3] Go Pensions (2024) DC Master trust league table 2024
[4] Nest (2024) Investment approach
[5] PPI (2021) What can other countries teach the UK about measuring value for money in pension schemes?

- 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.

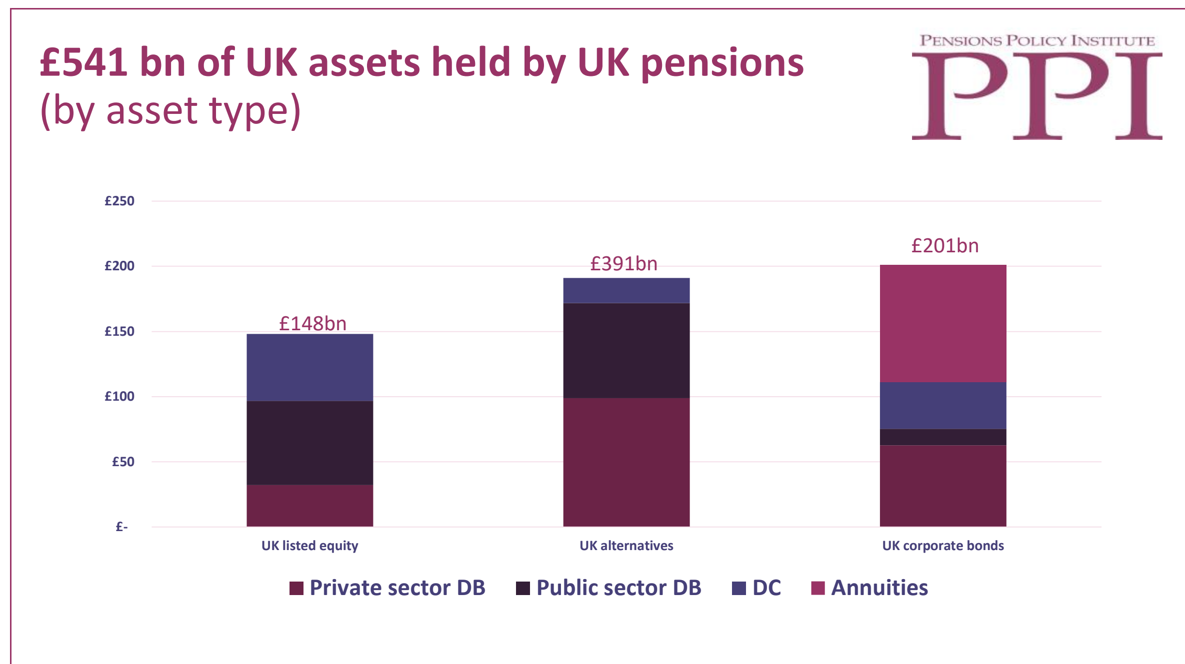
4. Investing in the UK[6]

4.1 Productive assets are estimated to account for 18% of the £3 trillion pension assets in the UK. Using a definition of UK productive finance 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%.

4.2 Significant differences exist between different types of pension scheme when it comes to investment in productive assets:

- 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 and proportion. Using FSPS data on geographic distribution, the PPI estimates that: £36bn is invested in UK corporate bonds; £51bn in listed UK equities; £21bn in UK property; and £10bn invested in UK private equity and alternatives – totaling £106bn and representing 4% of UK pension assets. In addition, approximately £118bn is invested in UK Government bonds, representing a further 4% of UK pension sector assets invested in the UK.

[6] PPI (2019) DC scheme investment in illiquid and alternative assets; PPI (2024) Pension scheme assets – how they are invested and how and why they change over time



4.3 DC schemes are increasingly exploring private markets and alternatives but some barriers remain.

DC scheme asset allocation 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.

However, even before the Mansion House compact, many DC schemes had begun to expand their exposure to private markets through private equity, venture capital, private credit, real estate and infrastructure investments, driven by the need for diversification in the portfolio and recognition that illiquid assets can yield higher returns (the illiquidity premium). A lack of positive correlation between public and private market performance and lower levels of volatility are also attractive features.

Historically, private markets have delivered good returns for investors. PPI has estimated that the illiquidity premia for private markets ranges from 1% to 7% over what could have been earned from other comparable liquid assets over the long term. However, some commentators, including the Bank of England[7], have expressed concerns about the sustainability of returns. The Financial Times (FT)[8] has reported concerns about the sustainability of private equity returns due to the maturity of the sector and higher borrowing costs.

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[7] Bank of England (2024) Financial Policy Summary and Record – March 2024
[8] FT (2024) Is private equity actually worth it?

4.4 The growth in private market assets will largely be driven by the very small number of open DB schemes in the public and private sectors and DC funds. However, the policy initiatives currently underway could lead to some unintended consequences:

- The potential for a herding effect with providers all putting more money into private equity at the same time, which could have a detrimental effect on asset prices and returns.
- A risk that disclosing asset allocation could lead to less innovation in asset allocation as schemes tend towards the mean.
- Disclosure could lead to a reduction in UK investment if it becomes more evident that schemes that are overweight in the UK are underperforming.
- Any attempt to force providers to invest more heavily in certain asset classes is a direct challenge to trustees' fiduciary duty and can be expected to be met with considerable backlash. The Government could also find itself in conflict with regulators, both of whom put member outcomes at the forefront of their strategies and policy.
- Changes such as the lifetime provider and the small pots initiative could disrupt the current trend towards consolidation and, with funds moving more between providers, could lead to providers needing to emphasise liquidity.

4.5 Members should benefit from shifts in asset allocation.

Members of DC schemes with a default fund should see better designed defaults, more diverse portfolios, better risk management and better returns as asset allocation becomes more sophisticated. However, charges may rise with the higher costs associated with some asset classes. This may be offset by the economies of scale and negotiating power of fewer, larger schemes. In addition to seeing their pensions yield better and more secure retirement incomes, DC members could also benefit from the societal improvements that successful investment in UK business should yield – more secure jobs, economic growth, wage growth and better public services.

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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.