Department
for Work &
Pensions

Facilitating investment in illiquid assets

Response to the ‘Enabling Investment in Productive Finance’ consultation

Consultation on new ‘Disclose and Explain’ proposals

Consultation on draft ‘Employer-related investment’ regulations

Response to the ‘Future of the defined contribution market’ call for evidence

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March 2022

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Introduction

This combined consultation seeks your views on policy proposals and draft regulations designed to improve the accessibility of illiquid assets for defined contribution pension schemes.

This document also provides responses to two recent consultations which have the same objective to enable investment in productive finance.

Ministerial Foreword

This will be a seminal year for value for money in defined contribution (DC) occupational pensions. In 2022, we will see DC schemes disclosing their investment performance for the very first time and small DC schemes going through a rigorous assessment to determine whether they offer value to their members. We will be monitoring the impact of these measures closely, but our attention now turns to building on this work, working with the Financial Conduct Authority and The Pensions Regulator to create a framework that works across the DC market.

Whilst this work continues, I am determined to pursue the path to opening illiquid asset classes to DC schemes. I am firmly of the view that all DC schemes should be considering diversifying their portfolio. For over a decade public market passive investment has been able to deliver strong returns for savers. This may well continue to be the case in the long-term, but it is right that trustees consider the role that illiquids can play in continuing to deliver the best possible opportunity of a comfortable retirement income for their members.

This consultation sets out the next steps of our plan to enable trustees to explore as diverse a range of assets as possible. This includes a response to the December 2021 charge cap consultation, which sought views on proposals to exclude performance fees from the 0.75% cap on charges in default arrangements. We want to ensure that, as we progress with this reform, trustees can get the best overall deal for members when investing in private equity and venture capital, balancing the potential benefits to members with the costs of paying higher than traditional fees.

We are inviting views on new proposals to require DC pension schemes to “disclose and explain” their policies on illiquid investment and for schemes with over £100million of assets to disclose their current asset classes to members. This is something many schemes already report, but we believe that making this a requirement would result in a significant shift in the mindset of pension schemes, their trustees and ensure consistency. By providing this information to members, employers, consultants, trustees and the market at-large, we hope to continue to

encourage competition based on overall value and as holistic a range of data as possible.

We are also proposing to bring forward legislation this year to reduce burdens on trustees and open up private markets further. We propose doing this by removing certain employer-related restrictions that currently apply to large authorised Master Trusts making compliance significantly easier. We believe this will ensure proportionate member protection is maintained whilst disproportionate red tape is removed simultaneously reducing the costs of investment in private equity and debt. This consultation seeks views on the draft regulations to deliver this.

I will also continue to champion the benefits of greater consolidation in the DC market to drive better outcomes for all members through improved governance and greater investment in illiquid assets. I have also published today a summary of the responses we received to the call for evidence on the future of the DC market I published in summer 2021.

Ensuring the DC market is fit for the future is a key priority. Innovating the DC investment offer, maintaining appropriate protection for automatically enrolled savers and improving the member experience can be achieved simultaneously if we work in a collaborative, open way.

Guy Opperman MP, Minister for Pensions and Financial Inclusion

About this document

Purpose of the consultation

This consultation package includes:

- the government's response to the 'Enabling Investment in Productive Finance' (charge cap reform) consultation (Chapter 1)
- a policy consultation on disclose and explain proposals to stimulate illiquid investments (Chapter 2)
- a consultation on draft regulations on Employer Related Investments (ERI) (Chapter 3)
- the government's response to a call for evidence 'Future of the defined contribution pension market: the case for greater consolidation' (Chapter 4).

Who this consultation is aimed at

We would particularly welcome responses from:

- pension scheme trustees and managers, particularly those from defined contribution (DC) occupational Master Trust schemes;
- pension scheme members and beneficiaries;
- pension scheme service providers, other industry bodies and professionals;
- civil society organisations; and
- any other interested stakeholders.

Scope of consultation

This consultation applies to Great Britain as pensions is a reserved matter for Scotland and Wales.

Occupational pensions are a devolved matter for Northern Ireland, and we are working closely with counterparts in Northern Ireland at the Department for Communities in relation to the matters set out in this consultation.

Duration of the consultation

The consultation period begins on 30 March 2022 and will run until 11 May 2022.

How to respond to this consultation

Please send your consultation responses on the template provided via email to:

DC Policy, Investment and Governance Team at the shared email address:

Email : PENSIONS.INVESTMENT@DWP.GOV.UK

Government response

We will publish the government response to the policy consultation on disclose and explain proposals on the GOV.UK website.

We will publish the government response to the consultation on draft regulations on the GOV.UK website at the same time as or before we lay the regulations in Parliament, should we pursue regulatory reform of employer-related investment rules.

How we consult

Consultation principles

This consultation is being conducted in line with the revised Cabinet Office consultation principles published in March 2018. These principles give clear guidance to government departments on conducting consultations.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments about the consultation process (as opposed to comments about the issues which are the subject of the consultation), including if you feel that the consultation does not adhere to the values expressed in the consultation principles or that the process could be improved, please address them to:

Email: caxtonhouse.legislation@dwp.gsi.gov.uk

Data Protection and Confidentiality

For this consultation, we will publish all responses except for those where the respondent indicates that they are an individual acting in a private capacity (e.g. a member of the public). All responses from organisations and individuals responding in a professional capacity will be published. We will remove email addresses and telephone numbers from these responses; but apart from this, we will publish them in full. For more information about what we do with personal data, you can read DWP's Personal Information Charter.

Chapter 1: Consultation Response - Exempting performance-based fees from the regulatory charge cap

Background

1. In the 'Enabling Investment in Productive Finance'[1] consultation published in November 2021, we reiterated the government's commitment to do all we can to make it easier for trustees and managers of occupational DC pension schemes to take advantage of long-term illiquid investment opportunities where they feel they are in their members' best interests.
2. One area we wanted to explore further, we explained, was the effect that 'performance fees', which can be part and parcel of accessing some illiquid assets, and that remain subject to the charge cap, may act as a significant barrier to trustees' of DC schemes investment decision-making when it comes to illiquid assets.
3. Industry feedback to previous DWP consultations: 'Incorporating performance fees within the charge cap'[2] and 'Improving outcomes for members of DC schemes'[3] on the interaction between performance fees, the charge cap and illiquid investment has consistently suggested that while not being the sole barrier, performance fees can discourage many trustees from selecting investments that would require them to allocate otherwise unused 'headroom' to such payments. The Pensions Charges Survey 2020[4] provides evidence that the current level of take-up of, or allocation to, illiquid assets by DC schemes showed two-thirds of providers had no direct investment in illiquid assets within their default arrangements.
4. Taking the feedback received previously from stakeholders on the barriers to illiquid investment, and drawing on the issues discussed in the recent reports by the Taskforce for Innovation, Growth and Regulatory Reform[5] and the Productive Finance Working Group[6], as well as our broader industry engagement, we sought to learn from this consultation what effect a possible reform to add performance-related fees to the list of charges outside of the scope of the charge cap could

[1] Enabling investment in productive finance - GOV.UK (www.gov.uk)
[2] Incorporating performance fees within the charge cap - GOV.UK (www.gov.uk)
[3] Improving outcomes for members of defined contribution pension schemes - GOV.UK (www.gov.uk)
[4] p26, Pension Charges Survey 2020 (publishing.service.gov.uk)

[5] Taskforce on Innovation, Growth and Regulatory Reform independent report - GOV.UK (www.gov.uk)
[6] A roadmap for increasing productive finance investment | Bank of England

have on pension schemes’ capacity and willingness to consider broadening their investment strategies.

5. We were clear in the consultation that this proposed exemption from the charge cap would only apply to well-designed performance fees that are paid when an asset manager exceeds pre-determined performance targets. All other charges currently in scope of the charge cap would remain. This includes, for example, the fixed fee part of a standard carried interest performance fee model – the 2% fee of the traditional 2 and 20 “carried interest” performance fee.

6. We were keen to receive feedback on whether stakeholders agreed with us that this proposed change could incentivise schemes and managers to reach fee agreements that link payment of additional fees directly to the net benefit the scheme members receives. What follows is a summary of the responses we received.

Overview of stakeholder responses

7. We received a total of 54 responses from a mix of organisations across the industry, including from 16 investment management firms and financial services representatives; 13 trustee service bodies (advisers, actuaries, consultants, administrators, professional trustees, law firms and their representatives); 11 Master Trusts; 5 individuals; 3 trade associations; and 1 response each from a trade union, insurance firm, social enterprise, research organisation, business organisation, and a consumer group. A full list of respondents can be found at Annex A.

8. Broadly, the responses received from the financial services sector and some Master Trusts welcomed the proposal. They reported that the charge cap currently limits DC schemes’ ability to invest in illiquid assets that come with performance fees. They welcomed the proposed measure as a positive step toward removing a barrier, which if implemented had the potential to open doors to pension schemes to access private markets in greater numbers than before, to the benefit of savers.

9. Generally, the responses received from trustees' service and legal advisory bodies, along with other Master Trusts, said they were not convinced that the proposed change was enough to incentivise DC schemes to change their current approach to investing in illiquid assets that come with performance fees. Some believed our proposal may in fact be counter-productive to the objective to increase investment in productive finance and increase transparency in financial services.

10. A variety of organisations representing different consumer and trade groups strongly opposed the proposal, stating that there was a lack of supporting evidence for such a change, and that in their view excluding performance-based

fees from the charge cap would dilute the charge cap which has proved to be very effective in protecting members from higher charges.

11. Almost all respondents called for DWP to ensure that any regulatory changes planned have the necessary safeguards in place to ensure effective member protection. There was a consensus that to achieve this there would need to be more discussion across the sector on the detailed development of the policy, including informative guidance to help trustees of DC schemes apply this. Furthermore, that this work should be done at a measured pace.

Stakeholder responses to consultation questions

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so, would this change increase how much you invest? If you do not currently invest in such assets would this change, make it more likely for you to, and do you have an idea of to what % of Assets Under Management that might be?

Question 1b: Would adding performance-based fees to the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

Question 1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

12. Many respondents spoke positively to the proposal to add performance-based fees to the list of charges outside the scope of the charge cap. Several said they believed it had the potential to help eliminate the uncertainty trustees of DC schemes currently faced when trying to reconcile whether they can invest in certain illiquid assets that come with performance fees with the fear that in doing so they would breach the charge cap rules.

    "The more fees are incorporated in the cap, the more restricted investment options become for these schemes... This measure will therefore make it easier for DC schemes to access new asset classes in areas such as venture capital, and it will do so without opening trustees and investors up to additional risk."
    Octopus Group

    "DC schemes may be competing against other investors who are willing to pay the fees set by the market. Being constrained by an inability to pay performance fees could see DC schemes unable to invest in these strategies, thus missing out

on the return and diversification benefits that they offer." **The Investment Association**

13. Many respondents said they saw this change over time having a positive effect on increasing DC schemes' appetite to investing more in illiquid assets from a currently low base now.

    "We are not currently investing in these types of assets, but this change would certainly encourage the trustees to do so – potentially as much as 15-20% subject to satisfying liquidity and diversity requirements." **BCF Pensions**

    "Our DC pension trustee clients are more likely to invest in productive assets if performance fees are taken out of the charge cap." **Simmons & Simmons**

14. Several respondents said they saw this change had the potential to open competition up within the private markets sector and incentivise investment managers to target outperformance, with less emphasis on flat rate management fees. In turn creating better opportunities for pension schemes and the investment community to agree more flexible fee structures.

    "The charge cap is not the only driver of this focus, but it is highly influential and seen as an unpassable barrier for many in the pensions industry. We believe this will help facilitate fresh discussions between the venture capital industry and the pensions industries on fee structures that work for both sides." **UK Bioindustry Association**

15. Several respondents suggested this change could also help to change the current focus of pension schemes from one of keeping costs low to instead a wider assessment of the value achieved by seeking higher returns for members.

    "Pursuing these opportunities can, as a consequence, entail higher costs. In return investors have the opportunity to access potentially higher returns, which can help to increase the size of their pensions pot and improve their outcomes in retirement." **M&G**

16. Most responses, however, were negative to the proposed change. Many saw the exclusion of performance-based fees from the charge cap, while potentially enhancing DC schemes' ability to invest in illiquids, as unlikely to move trustees from their current reticence to do so. One of the reasons given for this was that even with this change most DC schemes would still lack the economies of scale, expertise and resource required to access and manage more complex investments.

    "Excluding performance fees from the charge cap would remove a concern which may deter some DC schemes from investing in private equity or venture capital. However, other concerns may remain… lack of scale for many DC schemes; lack of expertise in decision-making; maintaining appropriate liquidity in the DC pension scheme's portfolio and member perception/understanding." **Society of Pensions Professionals**

17. We received feedback pointing to the other barriers DC schemes face when investing in illiquid assets, such as, a lack of quality products, appropriate valuation platforms and flexible pricing structures. Several respondents went further by calling on the investment community to be more proactive in introducing new illiquid options that come with liquidity, and that are ‘platform-friendly’. Some suggested they must also look to develop more products that come without performance fees.

    “Adding Performance fees to the list of exempt charges would increase the existing appetite for illiquid assets - and is helpful. But it is not the main barrier – the key factor is the lack of availability of quality funds at the right price and with the right characteristics.” **Tesco**

18. A few responses pointed to the fact that larger schemes, including Master Trusts are unlikely to consider increased investment to illiquid assets as being as much of a priority as ensuring costs are low for members, to maintain their competitive status within the market.

    “Regulatory rule changes such as those proposed are, in our view, likely to reinforce the industry’s focus on absolute costs and charges, rather than improving net member outcomes.” **Hymans Robertson**

19. Several respondents said removing performance fees from the cap would act more as a hindrance rather than a help to many DC schemes’ efforts over recent times to convince private markets to reduce their fees, or to do without them altogether.

    “Moving more cost items outside of the charge cap only discourages investing in private markets-related investments. Investors cannot control returns, but they can control their investment costs and can shop around for products and services accordingly.” **The Transparency Taskforce**

    “This could potentially be counterproductive as it could reduce the bargaining power of DC schemes to demand alternatives to performance fees.” **Association of Consulting Actuaries**

20. Many respondents were more critical in their appraisal of the proposal citing that there was little independent evidence that investments in private markets directly benefit DC savers.

    “No evidence to suggest that performance fees improve customer outcomes and we do not see a need for performance fees to be permitted in default funds in the first place. The charge cap offers valuable protection to savers.” **Scottish Widows**

    “The case has not been made for diluting the charge cap, which has been successful in protecting members in DC schemes from excessive charges. It could leave members at risk of having their pots eroded by higher fees, and it is

unlikely to lead to a significant change increase in DC allocations.” **Trade Union Congress**

21. Many respondents said the proposed changes were the reverse to trying to challenge asset managers to encourage and/or better accommodate the needs of pension schemes to want to invest in private markets, for example, by introducing more flexible/innovative fee structures.

“Access to the DC marketplace would be lucrative, yet there is seemingly little appetite for change from within the investment industry. They continue to hold their ground and demand that the pensions industry pays the fees on their terms.” **Age UK**

“There is a strong case that asset managers could have evolved their fees within the charge cap, and so at this stage we remain unconvinced that the effective removal of the cap for those working with some asset classes will result in a period of fee innovation in a way that has so far been lacking.” **Pensions & Lifetime Savings Association**

22. In response to the question about what alternative measures to the proposal could be considered that would help encourage take up of illiquid investment we received several suggestions, including how trustees might be required to explain to members their policy on investing in illiquids. This is the option we have outlined in chapter 2 to this document.

“We believe DWP need to think of more radical solutions in this space, for example: compelling schemes to state why they do not have an allocation to illiquid assets in value for member disclosures/chair statements.” **Isio**

23. Other suggestions were for solutions to be found that deal with daily dealing and asymmetric fee arrangements, and for more guidance to be given to DC schemes on what is required when investing in illiquid assets to improve understanding and allay concerns.

“Providing fair daily prices for funds investing in illiquid assets or comfort to trustees on the level or proxy or stale pricing that is reasonable. Trustees rightly feel that moving from daily pricing to less frequent pricing causes additional risks to members.” **Lane Clark Peacock**

“Further trustee education on the benefits and workings of long-term illiquid investments is needed to provide better training on financial awareness for those with authority for investment decisions or strategy.” **Macquarie Asset Management**

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

Question 2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

24. Many respondents explained that key to ensuring member protection from this proposed change would be the existing fiduciary duty of trustees; ensuring fee structures worked for their scheme and are only earned if higher performance is delivered.

    “Trustees have a fiduciary duty to make informed decisions on fund investments and must obtain advice on investment options from investment professionals before making an investment decision.” **Simmons & Simmons**

25. Several responses suggested that one way of ensuring trustees were complying with their duty to ensure members were receiving value for money on performance-fee linked investments, would be to require this to be covered as a requirement when they carry out the value for member assessment each year.

    “Trustees are ultimately responsible for assessing if each fund’s charges are good value. This would be assessed at selection and on an ongoing basis in the Value for Member assessment.” **Lane Clark Peacock**

26. In terms of ensuring members are only required to pay fees when genuine outperformance is achieved, many responses clarified that the market is already well-established in ensuring investors are only charged for the performance achieved. Most respondents were therefore in favour of negotiated agreement between the trustee and asset manager on what fees structure worked best.

    “Fee structures are agreed between the client and fund manager based on needs and expected returns. It would be unhelpful to hard-wire any specific and pre-determined structures into the cap rules.” **The Investment & Savings Alliance**

27. Some respondents however expressed caution that many trustees presently may lack the required skills and expertise in understanding fee structures and certain illiquid asset classes, and so there is potential risk in presenting to them the option of excluding fees from the cap without proper advice or guidance.

    “Market competition is the best control to keep fees competitive, but this requires trustees of DC schemes to develop the skills to understand the fee implications of the products into which they are investing and also to better understand and evaluate the performance of those products.” **John Forbes Consulting**

28. There was a consensus among respondents that guidance on what constitutes well designed structures would be needed, that this should look to build on existing best practice already in the market but could also include, for example, detailed scenario planning and illustrations of charges, acceptable treatment of hurdles rates or high-water marks, clawback provisions, as appropriate.

    "There is already a significant amount of regulatory and supervisory material relating to fee structures in the asset management sector, including from the FCA, ESMA and IOSCO[7]". **Apex Group**

    "It would be hoped that trustees would simply not invest in an arrangement with poorly designed performance fees, but they may need assistance carrying out proper scenario modelling." **Aegon**

29. Many pointed to the need for guidance specifically to cover the point about the timing of performance fee deductions from members' pots, taking account of fair apportionment to scheme joiners and leavers, as well as helpful suggestions to how this barrier could be alleviated.

    "Timing and fair treatment of members is something that should we think should be addressed in guidance for trustees and has been covered in existing standards." **The Investment & Savings Alliance**

30. In response to the question whether the proposed change could have an unintended consequence of seeing investments that currently do not come with performance fees, now including these, we received advice to the contrary.

    "We do not see a significant risk of the proposed changes leading to performance fees being charged for strategies which did not apply them in the past. Industry practises around fee structures are already well-established and underpinned by international and regional rules and standards." **BlackRock**

31. We also received some support for the investment sector to consider alternatives to more traditional fee structures, with some respondents reporting it was likely we would see more flexibility applied as more pension schemes begin to explore investing in illiquids.

    "Some managers with management fee levels close to the cap may be tempted to reduce management fees below the cap, so as to open their products up to DC schemes." **Pinsent Masons**

[7] See COLL 6.7 Payments - FCA Handbook, https://www.esma.europa.eu/document/guidelines-performance-fees-in-ucits-and-certain-types-aifs and https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

Question 3: Which of these conditions should the government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

32. We sought views on the types of conditions we were aware can be applied to performance fee structures, and whether it would be appropriate to apply these in any regulatory changes or guidance to support the proposal. The principles we listed were as follows:
    - typical hurdle rates across different asset classes.
    - accrual methodologies for performance fees.
    - linking performance fees directly to realised profits.
    - circumstances when caps on performance-fee-incurring assets within the portfolio might be appropriate.
    - incentivising the development of alternative fee methodologies such as ‘1 and 30’.
    - requirements for a high-water mark; and
    - banning the practice of clawback.
33. We received a mixed response to introducing prescriptive conditions to performance-based fee structures within the confines of any new regulations. As referenced in the summary to question 2, respondents were largely against the idea of prescriptive conditions, as they thought this would limit the ability of trustees and asset managers to negotiate the best terms in the interests of members, and it was also said to be difficult to set fee design given the many variables, different asset classes, and in an evolving market.

    *“*Government shouldn’t undermine efforts by the pensions industry to negotiate better fee structures with fund managers. Schemes with larger assets under management will be able to negotiate better fee arrangements and when economies of scale are reached, it is likely these products will be made available to the wider market”. **Hymans Robertson**
34. We received a few similar comments that it should be for regulators and not the government to advise on the design of performance fee structures.

    “We take the view that it is the role of the FCA to ensure that all fee structure design is fair and in the interests of members – we do not believe that this is something that should be determined through DWP’s charge cap regulations.” **Pensions & Lifetime Savings Association**
35. Some responses however did say that setting conditions, such as, hurdle rates, high water marks and appropriate preferred returns may serve a useful purpose in ensuring members are only charged once outperformance had been achieved.

This was highlighted as important to give confidence to trustees to invest without the full safety of the charge cap.

“Trustees will need to ensure fee structures are designed appropriately, to incorporate suitable hurdle rates of returns but also ensure investment managers do not take too much risk.” **Aon**

36. This was similarly the case in relation to the question about potentially banning clawback as a condition for the removal of performance-based fees from the charge cap. Several respondents argued that clawback allows for flexibility, rarely impacts and is seen as a form of member protection.

    “Clawback is an investor protection and should be retained.” **BGF**

37. Most respondents were against the idea of capping performance-fee-incurring assets within a portfolio as they saw this should be up to the trustees of DC schemes to decide on the level of allocation and what they are willing to pay for the service provided.

    “We do not believe an arbitrary cap, through a cap on performance fees, on the allocation to illiquids will be necessary.” **Aon**

38. Several respondents supported the use of accrual methodologies that allow investors to pay performance fees only once investments are realised as a condition. It was explained that this has the benefit of ensuring that investors who move in and out of funds during periods of strong performance are charged part of the performance fee, although the investment manager will only receive such monies once the underlying investment is finally realised/sold. In this respect respondents were more in favour of linking performance fees directly to realised profits.

    “We believe this is sensible, to ensure the fair charging of members who may be moving in or out. This is a particular area we believe should be addressed in the suggested guidance, as the question of ‘fairness’ in this context is a longstanding concern (and therefore acts as a barrier).” **J.P. Morgan**

39. Whilst the majority view was that fee structures should be left to trustees and asset managers to negotiate what worked best, and that this could mean standard carried interest model such as the 2:20 model being retained, we also received support for the idea of alternative fee methodologies such as a '1 and 30' model. For example, some respondents saw the benefit of asset managers lowering the fixed management element of fees to be compensated by increased (realised) performance.

    “Examples of managers lowering management fees but being compensated by increased (realised) performance fees could be attractive to both investor and manager.” **Partners Group**

40. In response to whether an exemption of performance-based fees from the charge cap should apply to all assets, and not be limited to specific asset classes, respondents broadly agreed with this principle.

"We therefore do not believe it is necessary or desirable to specify the asset classes to which the exemption would apply. Indeed, doing so would present practical challenges in defining how portfolios would qualify for each category; and thereby create the risk of regulatory arbitrage". **BlackRock**

41. Further to this we received an interesting suggestion that there might be a role for Regulators in providing a performance calculation to help ensure consistency and fairness across asset classes and fund managers.

    "It will be essential to have a consistent framework for calculation of performance-based fees (similar to the guidance on slippage-cost methodology that was provided for the calculation of transaction costs for reporting purposes) and it would be helpful for this to be set out in the regulations." **Association of Consulting Actuaries**

42. As outlined in the response to question 2, there was a strong preference for any fee structures calculations, methodology and conditions to be applied in principle-based guidance which built on established best market practice.

    "There are FCA principle-based guidelines on the use of performance fees, covering the choice and application of benchmarks or hurdles, and guidance on accrual periods and disclosures." **The Investing & Savings Alliance**

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree?

Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

43. All respondents agreed with the proposal to require the disclosure of any performance-based fees excluded from the scope of the charge cap. Many pointed to how important it was for disclosure of fees paid to be communicated clearly to members, and that ensuring trustees are provided with the information they need to report would help instil confidence.

    "We support moves to remove performance fees from the charge cap, so long as these fees are not buried and obscured and protections are in place to safeguard savers' interests." **Smart Pensions**

    "All costs and charges involved in any investment, product or service must be disclosed to those who are paying for them and to those who are responsible for governance of the Workplace Pensions… It is 2022 and nothing else is acceptable." **Transparency Task Force**

44. It was suggested that if the disclosure appeared in the Chair's Statement, then it must be contextualised to ensure full understanding for members.

"There's an opportunity to provide simple transparency of charges to members, in the Chair's report (and Simpler Annual Statement), by showing the total returns over relevant period(s) – including and excluding total costs – with a breakdown of those costs and charges". **Tesco**

45. It was also suggested that the disclosure requirement should be viewed as reflecting the value of the investment more broadly rather than as a focus on costs incurred by members

"Disclosure obligations which give effect to this requirement should be proportionate and reflect the broader value of the investment (and the 'net of fees' return it delivers) rather than simply focusing on cost." **Simmons & Simmons**

46. In response to the question as to whether performance fees information should be disclosed in a similar way to how transaction costs are now recorded most respondents agreed this was sensible and in keeping with the requirement on trustees to disclose costs and charges to members whether inside or outside of the regulatory charge cap.

"Performance fees should be subject to similar levels of transparency as fees within the charge cap and treating them similarly to transaction costs is a useful way to achieve this." **Aviva**

47. Some respondents disagreed with this and said the two charges were very different with transaction costs more granular in nature. It was stated that with performance fees in particular further explanation would be required when presenting these charges to members.

"It is difficult to disclose in a similar way to transaction costs because an "if they are paid" and an "if they are not paid" scenario would need to be considered, which doubles the number of already numerous projections required."
Association of Consulting Actuaries

48. Many comments received on disclosure concerned whether trustees would be able to collect the data from asset managers in such a way to be able to clearly articulate this to members.

"To make sure this works in a joined-up way, it makes sense to require managers to provide the relevant costs & charges information – to equip schemes to satisfy assessment, reporting and disclosure requirements. This is the same as the arrangement now in place for transaction costs." **Pinsent Masons**

49. Several respondents recommended the wider adoption of the use of industry designed templates, such as, the Cost Transparency Initiative templates could help ensure information was recorded and uniformly provided for this purpose.

"The PLSA, alongside the Investment Associate and the Local government Association, have set up and support an industry standard for institutional investment cost data – the Cost Transparency Initiative… a set of templates and

tools which together form a framework that investors can use to receive standardised cost and charges information from asset managers.” **Pensions and Lifetime Savings Association**

50. In terms of the likely cost of any additional disclosure requirements many of the comments we received suggested respondents did not anticipate this would bring about any significant cost. It was explained that fund managers should already have the calculations to hand and current disclosure requirements mean there will not be any extra cost in reporting.

    “We do not anticipate high additional financial costs arising from a requirement for disclosure, as this should align reasonably closely with existing disclosure requirements.” **Barnett Waddingham**

51. Alternatively, a few respondents believed there may be some costs involved in terms of data collection, creating a new fees calculation methodology and changing disclosure process across industry. They said this might become apparent once they had sight of further policy development.

    “Transaction cost methodology and calculations are treacherous – although some aspects, such as averaging over a period, could be carried over. A method would need to be determined for the disclosure of the performance fees - that will incur costs.” **Hymans Robertson**

Question 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

Question 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so, what do these transitional arrangements look like?

52. In October 2021, legislative changes[8] introduced, allow trustees of DC default funds flexibility to incorporate the presence of performance fees within their charge cap calculations. Firstly, they provide an option to exclude performance fees from their pro-rated calculations where members are invested for only part of a charge year; known as the ‘in-year adjustment’. Secondly, an option to smooth the incurrence of performance fees over a five-year moving average when assessing compliance with the charge cap. Given the proposed change outlined is to exclude performance-based fees from the charge cap, we asked whether there was still a place for either option to be retained.

[8] The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021

53. Most respondents agreed that if performance fees are removed from the charge cap, then both the pro-rated easement and smoothing mechanism options, recently introduced, could be removed without disadvantaging schemes/ members. It was reported that there was very little evidence of schemes using or planning to make use of these mechanisms.

    “These easements only came into effect from 1 October 2021 and we do not believe that many schemes (if any) have yet relied upon them.” **Lane Clark Peacock**

54. Some respondents disagreed slightly with this approach, stating that, as the measures had only just been introduced its impact or wider use is largely unknown. To this end, some respondents suggested introducing transitional arrangements to protect any scheme currently applying these mechanisms.

    “We suggest transitional measures or grandfathering is introduced, to ensure investment structure and fee arrangements are not un-duly impacted.” **Simmons & Simmons**

55. Some responses suggested that even with the option to exclude performance-based fees from the cap, trustees may still like or opt instead to use smoothing option instead if they view these offer members better value or protection.

    “Schemes should be allowed to continue to benefit from the smoothing mechanism so that fee structures can be re-negotiated in the light of the proposed charge cap exemption.” **Pinsent Masons**

56. In response to the question of how costly it might for some schemes to reverse the decisions to incorporate, for example, the smoothing mechanism some respondents suggested that if any schemes had made plans to do so then to prevent them now doing so could incur some cost to those schemes explaining to members why they are being charged more.

    “The small number of schemes who may be utilising the performance fee smoothing mechanism (as a charge) over a five-year period who would now need to charge the full performance once such fee no longer forms part of the cap charge, this may result in a significant move in the (i) total expense ratio and (ii) net performance.” **Partners Group**

Government Response

57. We are pleased with the number and level of detailed responses we received. From the outset we recognised that any proposal that suggests a reform, even a partial one, to the regulatory charge cap that applies to the default funds of occupational DC pension schemes used for automatic enrolment, which since its introduction has been pivotal to ensuring pension savers are protected from excessively high and unfair charges, would be met with a certain degree of concern.

58. As we explained in the consultation, we believe that this proposal may lead the way to give DC schemes that want to explore investing in illiquid assets that come with performance fees, the flexibility and freedom to enter into these arrangements if they think this will be in the financial interest of members. We also hoped this proposed measure could incentivise asset managers to design a new fees structure in the future that schemes are more willing to pay.

59. We have therefore taken on board the mixed reaction to this proposed change. We are pleased with the positive support it generated from many that this change has the potential to remove a real barrier to schemes that want to invest in illiquid assets, as well as open doors for greater engagement between pension schemes and the investment community, which may currently appear stalled.

60. However, as the summary of responses outlined above details, we recognise that the proposed change was not positively received or supported across the entirety of the pensions sector and other interested groups more widely. DWP consults and engages with a very wide range of stakeholders when formulating proposals and deciding to pursue reform. We will continue to do so as part of our next steps.

61. That said, we believe, it is important for the government to take time to fully understand all the concerns raised, engage further, and to explore how these concerns might be addressed in the design of the policy as we pursue this further.

62. This will mean any reforms should be careful but precise. For example, respondents told us that disclosure of performance fees is essential. We will pursue this aspect of the policy design, but it will take careful consideration to ensure the right information is disclosed, in the right format, for the right audience with proportionate burdens on trustees.

63. Changes we propose will be intended to first and foremost ensure members are sufficiently protected. We are encouraged by the feedback we received that the policy intention we set out to only exempt ‘well-designed’ performance fees that are paid when an asset manager exceeds pre-determined performance targets is well intended. However, we recognise that all performance fees are not created equal and that the concept may be new to trustees. Therefore, we intend to consult on principle-based draft guidance alongside any proposed consultation on draft regulations.

Chapter 2: Introducing Disclose and Explain Policy Proposals

Policy Proposals

64. We propose to amend the Statement of Investment Principles (SIP) requirements to ensure that relevant defined contribution (DC) pension schemes disclose and explain their policies on illiquid investment.
65. We also propose to introduce regulations that require relevant DC schemes with over £100million in total assets to publicly disclose and explain their default asset class allocation in their annual Chair's Statement.

Background

66. Back in 2019, in response to the Patient Capital Review of November 2017[9], we consulted on proposals[10] to facilitate investment by DC schemes in less liquid assets.
67. Question 1 consulted on proposals for schemes to report their policies on illiquid investment in their Statement of Investment Principles as well as proposals for schemes to annually report the approximate percentage holdings in illiquid assets of their default arrangement. The consultation sought stakeholders' views on the proposed policy and what the scope of these proposed requirements should be.
68. Responses to Question 1 were broadly supportive of our proposals but a few stakeholders responded with scepticism. The proposals were paused after the consultation to monitor market developments and to adapt policy in response to stakeholder suggestions.

Rationale for intervention

69. Since 2019, our focus on enabling DC pension schemes to access as diverse a range of assets as possible has grown. We have made changes to regulations and guidance to encourage trustees to take a holistic approach to value for money, to begin to compete based on net investment returns and to have as much freedom as possible to explore illiquid assets. We have observed a significant increase in DC schemes' appetite for investing in illiquid assets, but we believe more can be done to demonstrate to trustees that illiquid assets are not

[9] Patient Capital Review - GOV.UK (www.gov.uk)
[10] Defined contribution pensions: investments and consolidation - GOV.UK (www.gov.uk)

off the table, as some have inferred in the past, and that they could provide members with higher net returns.

70. Some have advocated for government to adopt an even stronger position on exploration of illiquid assets, perhaps by requiring pension schemes to allocate a certain percentage of total assets towards private markets. This external pressure was referenced in the joint letter issued by the Chancellor and the Prime Minister calling for an 'Investment Big Bang'.[11]

71. The letter acknowledges that "choosing which assets to invest in to secure the best outcomes remains a matter for pension fund trustees, and other custodians of institutional capital." We believe that any attempt to force private pension schemes to invest in specific asset classes or sectors would cut across the fiduciary duty to which trustees must adhere and the independence of pension scheme trustees from government policy objectives. Rather than encourage investment in only one asset class or sector, we want to encourage further diversification and investment in assets that bring higher returns.

72. That is why we are now proposing to require schemes to disclose their policy on investment in illiquid assets within their Statement of Investment Principles. This consultation also proposes requiring large DC schemes to publicly disclose their asset allocation in their annual Chair's Statement.

73. We are seeking to encourage greater competition and innovation based on overall value for money in the DC market. If all agents have access to asset allocation information, we believe members, employers, consultants will be able to compare schemes alongside other key metrics, including the scheme's net investment returns, charges and quality of service. In this vein, we believe this will complement the work of the FCA and The Pensions Regulator (TPR) to create a single framework for value for money in DC pensions.

74. There is precedent for this kind of disclosure. Some Master Trusts already voluntarily report their asset allocation through the Corporate Adviser Pensions Average (CAPA) data which forms part of the Corporate Adviser "Master Trust and GPP Defaults Report."[12]

75. Also, internationally, Australian superannuation funds have already been required to publicly disclose their asset class allocations for many years. These regulations have been supported by industry. However, Australian superannuation funds have recently been required to report each asset's identity, value and weighting in the Product Disclosure Statements published on their websites. This is not a level of detail we are looking to emulate.

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[11] Prime Minister and Chancellor challenge UK investors to create an 'Investment Big Bang' in Britain - GOV.UK (www.gov.uk)

[12] capaDATA - capaDATA (capa-data.com)

Investment Evolution and Fiduciary Duty

76. Low risk, passive investment in index trackers and other low-cost assets has led to good, stable returns for DC schemes for at least a decade but this will not necessarily continue into the future. A shift is already happening across industry away from focussing on cost alone towards a focus on overall value for members. Less liquid assets have the potential to offer members higher net returns in the long-term, especially within a diversified portfolio that balances risk with opportunity.
77. In this rapidly changing investment environment in both public and private markets, these policies aim to encourage trustees to acknowledge the evolution of investment approaches already happening. We want trustees to actively reflect on whether their current investment policies and asset allocations align with these market changes and if their current offerings are still in their members' best interests.
78. We are not requiring trustees or investment managers to change their asset allocation as a result of these regulations but rather to reflect on the decisions they have already made, and the decisions they will make, as part of their ongoing fiduciary duty to create an investment approach that works optimally for members.
79. These policy proposals attempt to break down some of the systemic barriers to illiquid investment and give the opportunity for trustees to truly consider investment in private markets. Of course, it must still be the responsibility of trustees to decide where they invest, and we will not be mandating investment in certain assets. However, this policy could help shift focus from cost to value with trustees giving more weight to the decision of whether to invest in illiquid assets.
80. This policy does not represent a silver bullet. None of the proposals or regulatory changes we have made in and of themselves represent 'the solution' to the barriers to accessing illiquid investments. For example, we are aware that there continues to be a need for investment platforms to innovate to accommodate long-term illiquid investments. At a higher level, a cultural shift across the market needs to take place to make less liquid assets a genuine option for DC scheme trustees, and we hope that this policy will trigger such a shift.

Value for Money

81. The motivation behind these proposals aligns with work being done by DWP, FCA and TPR on ensuring value for money and investment in the best interests of scheme members. By increasing investment policy and asset allocation transparency, we hope trustees, employers and consultants will more fully understand the relative value a pension is offering members. This kind of disclosure may then facilitate greater long-term thinking about which provider or which type of pension is most appropriate for a set of members.

82. These proposals may also help members to be able to better understand the investments made on their behalf as well as potentially engaging with the projects they are funding which has the potential to drive up overall pensions' engagement. Productive finance and less liquid assets have the potential to bring members higher returns over the long-term as well as contributing to an overall value for money that isn't just focussed on cost. For example, some illiquid assets, such as green infrastructure projects or technology start-ups, could significantly contribute to our society, to the overall benefit of scheme members.

> **Question 1:** Do you support these proposals and agree with the government's rationale for intervention?

Amendments to the Statement of Investment Principles

Summary of proposal

83. We propose to require DC schemes to include an explanatory statement on their policy towards investment in illiquid assets in their triennial SIPs. Below we clarify exactly what we would like to see within these disclosures.

84. We would like trustees to have a platform to describe the average percentage holding and type of illiquid assets they have in their default asset allocation and the benefits they feel these assets bring to their scheme and members.

85. Conversely, we would also like to understand why other schemes choose not to include these assets in their default arrangements.

Scope

86. This consultation currently applies to default arrangements of occupational DC schemes only. Defined benefit (DB) schemes would not be affected by these proposals nor will self-select funds.

87. We propose to add a requirement to regulation 2(3) of The Occupational Pension Schemes (Investment) Regulations 2005[13], which will **only apply to** DC schemes, requiring them to include an explanation of their policy on illiquid investment.

88. The DB market structure is significantly different to DC. There is already a history of investment in illiquid assets in DB. Furthermore, many DB schemes are currently on a de-risking pathway, especially closed schemes. Given that most DB

[13] The Occupational Pension Schemes (Investment) Regulations 2005 (legislation.gov.uk)

schemes are now closed either to new members or to new accrual, and the time horizon before benefits have to be paid is contracting, there is a much reduced need for employers, members, or other interested parties to focus on illiquid investment policies. We therefore propose to exclude them from these policies.

89. For hybrid schemes, those that include both DB and DC section, we propose that any future requirements apply only to the DC section(s) of such a scheme.

Question 2: Do you agree with the scope of this proposal?

Definition of illiquid assets

90. One of the key areas of stakeholder feedback from our previous consultation in 2019 was around the definition of illiquid assets.

91. This is a difficult definition to articulate in regulations to ensure we capture the right group of investments. We lay out two options below on which we would value stakeholder input.

    - **Option 1**: Illiquid assets could be defined at the fund/vehicle level. Schemes use a range of different vehicles to invest in illiquid assets. Some of these vehicles are in effect liquid i.e. they (or shares in them) can be traded frequently and sold with ease despite investing in illiquid assets. We could specify that, given almost all DC scheme investment is done indirectly, illiquid funds or illiquid vehicles are the more appropriate subsection of investment options to hold a policy on. Funds could be deemed as illiquid once they reach a certain percentage threshold of their allocation being illiquid.
    - **Option 2:** Illiquid assets could be defined at the more granular asset level. If the investment itself is not able to be sold frequently, perhaps daily, this could be counted as an illiquid asset no matter the investment vehicle through which this is disclosed. This could be done by listing asset classes that are considered illiquid. This would require a scheme to 'look-through', for example, a multi-asset fund to understand the allocation within a particular fund.

92. Option 1 alone would capture illiquid assets held in fully liquid vehicles. For example, whilst the investment may be in shares of a private company or in a social housing development, it may be done by investing in a listed investment company. This would be cast by many as not a true illiquid investment, unable to access the 'illiquidity premium'. The 'equity wrapper' that the investment company provides make the assets easier to trade therefore satisfy the trustees' caution to illiquidity but may be diluting the returns members receive.

93. If we only wanted to capture illiquid funds, in line with the above argument, then we could for example define illiquid assets as "assets that are not able to be sold without a significant notice period." Most illiquid funds (property funds and other

open-ended funds) would therefore be captured however investment companies and closed-end funds may not.

94. We aim to keep the scope of investments that trustees could report on as part of their illiquid assets policy as wide as possible. For example, a scheme could report that their policy on illiquid assets simply involves some allocation to a Undertakings for the Collective Investment in Transferable Securities (UCITS) multi-asset fund which has some allocation to infrastructure amongst a primary focus on listed equities and bonds. We aim to avoid defining illiquid assets according to the vehicle or the characteristics of the vehicle through which they are accessed. We are therefore currently more in favour of a definition aligned with Option 2.

Question 3: Considering the policy objective to require trustees to state a policy on investment in illiquids, how should we define “illiquid assets”?

Specific SIP illiquid policies

95. Although there is already the opportunity for schemes to disclose their policies on illiquid investment in their SIP, especially if they already disclose their liquidity risk management policies, most schemes are actively choosing not to explicitly do so.

96. We envisage the average illiquid assets policy statement to be minimum one paragraph, maximum three paragraphs. We do not want trustees to have to spend significant resources or time forming their ‘house view’ of the issues that keep illiquid asset allocation low within DC pensions. Similarly, it is not our intention for trustees to have an esoteric discussion amongst themselves, and with members, about the relative merits of, for example, closed-ended and open-ended fund structures or liquidity management governance.

97. We want members to understand why their pension scheme does not simply invest in equities and bonds. Alternatively, if trustees do not allocate to illiquid assets, we want members to understand why the scheme only invests in equities and bonds.

98. We would like statements to include reference to the following:

- what illiquid assets are;
- whether trustees choose to invest in illiquid assets;
- which members will be holding illiquid assets (does the scheme lifestyle members in and out of illiquid assets and at roughly what age?);
- a description of these allocations, including whether the investment is direct or indirect and under which asset classes the investments fall;

- why trustees decided to make an allocation to illiquid assets (this should include their assessment of the benefits to members of such an allocation);
    - If trustees do not decide to make an allocation to illiquid assets, why;
- what factors they consider when deciding whether to invest in these assets;
- any current barriers to investment in illiquid assets;
- any future plans for investment in illiquid assets.

Timeframe for disclosures

99. We propose that the timeframe for disclosure of illiquid policies should remain consistent with the requirement for disclosure that currently exists for the SIP that is ‘at least every three years and without delay after any significant change in investment policy’.

100. We think this is appropriate for two reasons. Creating a separate timeline for illiquid asset policy disclosure would create an unnecessary burden. Secondly, a scheme’s approach to illiquid assets is unlikely to change any more regularly than over a number of years – more frequent reporting would not tell members anything new.

Question 4: Do you agree with the proposed aspects of a scheme’s illiquid asset policy that we would require to be disclosed and timing of such disclosures?

Asset allocation disclosure

Summary of proposal

101. We propose to require DC schemes with over £100million assets under management, and which are required to produce a Chair’s Statement, to disclose the percentage of assets allocated in the default to each of the following seven main asset classes in their annual Chair’s Statement: cash; bonds; listed equities; private equity (including venture capital and growth equity); property; infrastructure; and private debt.

102. This list is broadly based on the asset classes reported in the Corporate Adviser “Master Trust and GPP Defaults Report” based on CAPA data[14] and the

[14] capaDATA - capaDATA (capa-data.com)

illiquid asset classes defined in the Pensions Policy Institute (PPI) report "Could DC pension default investment strategies better meet the needs of members?"[15]

103. As discussed in the rationale for intervention section above, we believe that this information is something members deserve to have access to. We believe that most providers agree as they offer this information to members via apps, letters, annual benefit statements, Chair's Statements etc.

104. However, disclosure is not uniform. This makes it difficult for members to compare across schemes but more importantly across the various pots that they may hold. It is broadly agreed that members should be better engaged with their pension, how their money is invested and be aware of pertinent information about their pensions to be able to compare between offerings.

105. As of this year, trustees of occupational DC pension schemes will also be required to disclose net investment returns to their members. This will give them one metric that will encompass both the price and the performance of their pension saving. It will enable members to see how their pension performs vs. other pots and other providers. However, we believe information about asset allocation can complement this information to ensure members have more comprehensive information at their fingertips. For example, a scheme may achieve higher net returns by, for example, 3 percentage points. If they are also doing this by investing in a diverse range of assets including illiquids, the member is right to question the asset allocation and the risk appetite of a poorer performing scheme.

106. We propose to issue guidance to describe the way in which we propose trustees should disclose this information. Issues that are discussed in this consultation document, for example, age-specific disclosures, averaging, presentation etc. would be tackled in guidance rather than hardcoding into regulation. We will aim to find the right balance between creating consistency and enabling trustees, who ultimately know their membership best, to be creative and adaptive.

Example of proposed disclosure:

Asset class	Percentage allocation – average 25 y/o (%)	Percentage allocation – average 45 y/o (%)	Percentage allocation – average 55 y/o (%)
Cash	**0.6**	**6.3**	**31.6**
Bonds	**12.3**	**39.3**	**37.2**
Corporate bonds	*8.1*	*22.6*	*18.7*

[15] 2022-02-02 Could DC pension default investment strategies better meet the needs of members? | Pensions Policy Institute

Government bonds	*2.7*	*9.4*	*12.3*
Other bonds	*1.5*	*7.3*	*6.2*
Listed equities	**75.6**	**43.7**	**22.9**
Private equity	**4.6**	**3.7**	**2.6**
Venture capital / growth equity	*0.9*	*0.7*	*0.3*
Property	**3.1**	**3.0**	**2.4**
Infrastructure	**2.2**	**2.0**	**1.8**
Private debt	**1.1**	**1.3**	**1.1**
Other	**0.5**	**0.7**	**0.4**

Figure 1:

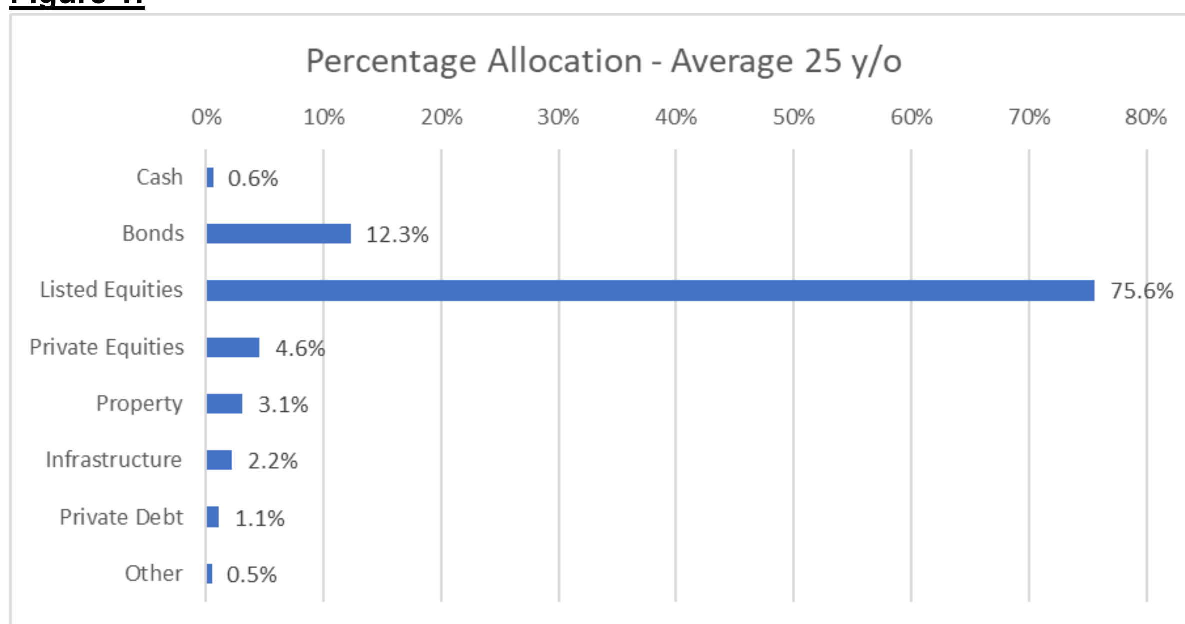

Figure 1 shows an example of a pension's scheme's average asset allocation for a 25-year-old saver. The largest allocation is "Listed equities", with 75.6%, and the smallest allocation is "others" with 0.5%.

107. This example is an illustrative representation of a pension scheme's asset allocation and does not represent DWP's understanding of best practice or attempt to represent any particular scheme in reality.

108. The example shows how trustees would be expected to report their asset allocation for each of the age cohorts in their annual Chair's Statement if disclose and explain regulations are taken forward.

109. The example is presented in both table and graph form. Since disclosure of this kind must be accessible to members as well as industry experts, we believe it is more likely that they will better understand and engage with a graph rather than the more inaccessible format of a table.

Question 5: Do you agree with the proposed level of granularity for this disclosure? Are the asset classes and sub-asset classes proposed in the example above appropriate for this kind of asset allocation disclosure?

Scope

110. We would only require DC schemes with over £100million in assets under management to disclose and explain their asset allocation in their annual Chair's Statement.

111. We would link determination of total assets to the latest version of the audited accounts, in the same way as the scope of the value for members' assessments was determined, set out in regulation 25(5) and (6) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996. In line with these regulations, a hybrid scheme would determine whether they are in scope based on consideration of total assets (DC + DB) and whether this figure is above or below £100million.

Question 6: Do you agree that holding £100million or more of total assets is an appropriate threshold for determining which DC schemes should be required to disclose asset allocation?

Age specific disclosures

112. We propose using age to represent the different asset allocation phases in accumulation. This aligns with the statutory guidance we issued alongside the new value for members' assessments - "Completing the annual Value for Members assessment and Reporting of Net Investment Returns" – that specifies that "trustees should show age specific results for savers aged 25, 45, and 55" in those disclosures.[16]

113. We are aware that some current disclosures of asset allocation and industry accumulation strategies use years from retirement rather than age when reporting

[16] Completing the annual Value for Members assessment and Reporting of Net Investment Returns - GOV.UK (www.gov.uk)

asset allocation and other data. Our first motivation is to be consistent with the disclosures that schemes are already required to produce in accordance with Regulation 23(1) aa of the Occupational Pension Schemes Administration Regulations 1996. However, it could be argued that 'years to retirement' is a better representation of the lifestyling approach taken in most default arrangements. We welcome views here.

Question 7: Do you agree that we should align the disclosures with the net returns' disclosure requirement?

Chair's Statement

114. We are proposing that asset allocation data be disclosed and explained within the annual Chair's Statement. This type of disclosure best fits within the Chair's Statement as it is already used for disclosure on the default arrangement and its governance; disclosure of net investment returns; disclosure of costs and charges; and trustee knowledge and understanding; among other things. Data and graphs are already frequently utilised within these statements and this kind of information would fit in well with the intended audience.

115. We are also proposing to require schemes to disclose asset allocation information, as outlined in the example above, publicly. As outlined in the rationale for intervention, the DC market needs to shift towards a consideration of overall value. We believe by having as much information available as possible, rather than simply the price of a particular arrangement, competition will be stimulated. Moreover, as part of our value for money work, DWP will seek to resolve the information asymmetry that currently precludes members from understanding how their pension performs relative to other providers. By having asset allocation information available for all alternative providers, transparency would be significantly improved.

Timeframe for disclosures

116. We propose that the timeframe for disclosures matches the timeframe for disclosures of net returns and therefore the publication of the Chair's Statement – annually. We are aware that many default arrangements adjust their allocation more frequently than this. We do not believe more regular disclosure would have enough benefit in terms of transparency and comparability in relation to the cost it would introduce for trustees.

117. However, in order to reflect the changes in the asset allocation that trustees may make during the course of a scheme year, we propose that trustees must use an average allocation. This should be done by selecting four valuation points throughout the year, no closer than three months apart, at which the percentage

allocation to each asset class is calculated. A mean average of these percentages should then be calculated and disclosed.

Question 8: Do you agree with the frequency and location of the proposed asset allocation disclosures?

Next Steps

118. We are committed to further stakeholder engagement throughout the policy development process. We are already working closely with a variety of stakeholders to make sure that the policy is created in the best interests of pension scheme members and with as little burden as possible to trustees across industry, but will be conducting further engagement where necessary during, but predominantly following, the close of the consultation.

Question 9: Please provide estimates of any new financial costs that could arise from the proposed "disclose and explain" requirements. Please outline any one-off and ongoing costs.

Chapter 3: Employer-related investments

Background

Relevant Legislation

119. In the 1990’s, legislation was introduced to restrict the extent to which trustees of occupational pension schemes could make investments that are connected with employers that sponsor or participate in the scheme (known as “employer-related investments”). This was to reduce the risk of a sponsoring employer misappropriating the schemes funds through loans and investments from the pension scheme.

120. Regulations were first introduced to restrict the proportion of scheme assets that could be invested by trustees of occupational pension schemes in ‘employer-related investments in the Occupational Pension Schemes (Investment of Scheme’s Resources) Regulations 1992)[17]. Further powers to restrict employer-related investments were introduced in the Pensions Act 1995 and detailed rules were set out in the Occupational Pension Schemes (Investment) Regulations 1996. These regulations have subsequently been revoked and replaced with the Occupational Pension Schemes (Investment) Regulations 2005 (”the 2005 Regulations”).[18]

121. The original legislation was based on the type of pensions available at the time, mostly single employer, defined benefit occupational pension schemes. In the majority of cases, there was just one employer running a pension scheme for its employees. The rules were designed to address the risk that a large portion of a scheme’s assets could be invested in the single employer and/or in persons associated with or connected to that employer, such as its subsidiaries, who had influence over the investment approach. Exercise of this influence in an inappropriate way may lead to a concentration of investment risk for pension scheme members which could ultimately result in them losing their pensions savings.

122. Section 40 of the Pensions Act 1995 provides that trustees or managers of an occupational pension scheme must comply with any restrictions on employer-related investments (“ERI”) that are set out in regulations. ERI are defined in

[17] The Occupational Pension Schemes (Investment of Scheme’s Resources) Regulations 1992 (legislation.gov.uk)
[18] The Occupational Pension Schemes (Investment) Regulations 2005 (legislation.gov.uk)

section 40(2) and in the 2005 Regulations. The 2005 Regulations also set out the restrictions that trustees and managers must comply with in relation to ERI.

123. The restrictions are set at different levels depending on the investment type. The two main types of investment in a particular company are debt and equity. In most cases debt involves the issuance of a loan from the investor (in this case the trustees of the pension scheme), to a particular company either via bonds issued by the company, a specific loan agreement or a fund that lends money to companies. In most cases equity involves buying a proportion of a company known as a share.

124. The restrictions at present are:

- a ban on certain loans of a pension scheme's assets to an employer that participates in the pension scheme[19]
- a limit on trustees and managers investing more than 5% of a scheme's assets in ERI
- for multi-employer schemes, a limit on trustees and managers investing more than 5% of a scheme's assets in any one participating employer with a cap of 20% on the total amount of a scheme's assets that are invested in ERI.

125. ERI also includes investments in 'associates' and 'connected persons' of any participating employer, using the definitions set out in the Insolvency Act 1986.[20]

126. Breach of the restrictions by trustees or managers is a criminal offence and as such can potentially lead to a fine and/or imprisonment.

127. The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013[21] also require trustees to provide a statement on request, identifying any employer-related investments made in a scheme year.

128. In addition to the above, the Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996[22] place a requirement on schemes to include details of any employer-related investments in their annual report and accounts.

Evolution of occupational pensions

129. The pensions landscape has evolved substantially since the introduction of the legislation some 30 years ago. The intervening years have seen the success of

[19] Note there are some exemptions to this ban, for example corporate bonds issued via a stock exchange.
[20] Insolvency Act 1986 (legislation.gov.uk)
[21] The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (legislation.gov.uk)
[22] The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 (legislation.gov.uk)

automatic enrolment (AE), the decline in popularity of defined benefit pension schemes, consequent rise of defined contribution (DC) schemes and the emergence of the Master Trust market.

130. DC Master Trust pension schemes are multi-employer occupational pension schemes that were developed to respond to the demand to accommodate the legal requirement for employers to automatically enrol their eligible employees into a pension scheme. According to data from The Pensions Regulator (TPR), authorised Master Trusts account for 20.5 million DC memberships.[23]

131. DC Master Trusts provided a solution for employers seeking to deliver their AE obligations, who wanted the advantages of a trust-based scheme without the cost and time of setting up and running their own arrangement.

132. A DC Master Trust scheme serves multiple unconnected employers. This contrasts with the multi-employer schemes in existence when the 2005 Regulations were introduced, which provided a workplace pension for a group of employers which are part of the same group of companies.

133. A DC Master Trust is a unique arrangement that simply did not exist in 2005. Generally, a Master Trust has a funder and a strategist which are often the same organisation. The scheme funder and/or strategist in most cases use the Master Trust that it funds/sponsors for its own employees' pensions.

134. The scheme funder and the scheme strategist are defined in section 39 of the Pension Schemes Act 2017 ("2017 Act").[24]

> **"Scheme funder"**, in relation to a Master Trust scheme, means a person who –
>
> (a) is liable to provide funds to or in respect of the scheme in circumstances where administration charges received from or in respect of members are not sufficient to cover the cost of establishing or running the scheme; or
>
> (b) is entitled to receive the profits of the scheme in circumstances where those charges exceed those costs.
>
> **"Scheme strategist"**, in relation to a Master Trust Scheme, means a person who is responsible for making business decisions relating to the commercial activities of the scheme.

135. As well as the scheme funder and the scheme strategist, some Master Trusts also have thousands of participating employers using the scheme as their occupational pension scheme for their employees. This number of employers means that the trustees of the Master Trust are restricted in their investment policy in relation to investments in any employer that participates in the Master

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[23] DC trust: scheme return data 2021 to 2022 | The Pensions Regulator

[24] Pension Schemes Act 2017 (legislation.gov.uk)

Trust and their associates and connected persons, which could relate to thousands of companies.

136. At the time of the introduction of the “the 2017 Act”, which set up an authorisation and supervision regime for Master Trusts, no changes were made to the ERI legislation to update the ERI requirements imposed on Master Trusts.

Rationale for update

Impact of 2005 Regulations on authorised Master Trusts

137. Master Trusts are multi-employer schemes and are therefore currently covered by regulation 16 of the 2005 Regulations.

138. Regulation 16 of the 2005 Regulations was designed for multi-employer schemes prevalent at the time the regulations were drafted. These schemes tended to be those in which the employers were connected or part of the same group of companies and so it could be argued that each employer was closely connected to the main sponsor of the scheme. Regulation 16 does not recognise the different structure of DC Master Trusts and neither acknowledges nor makes allowances for the altogether distinct relationship between the scheme and the multiple participating employers using the scheme to deliver their AE obligations.

139. The initial intent of the ERI restrictions was to restrict those employers who might influence investment policies, strategy, approach etc. from misappropriating the funds of the scheme. In the new landscape where multiple participating employers use the Master Trust as their means of complying with their AE obligations but operate entirely separately and at arm’s length to the scheme, thereby having negligible or nil influence on the investment strategy of the pension scheme, these restrictions go beyond the initial policy intent.

140. In spite of this lower risk relationship between the Master Trust scheme and the multiple participating employers, investments in the latter are caught by the definition of ‘employer-related investments’ and therefore trustees of the scheme must consider them when designing the investment strategy and monitor to ensure none of the multiple participating employers or their associates or connected persons have any involvement in any of the direct loans or in more than 5% of the investments in any single employer (or 20% of the investments overall) the Master Trust makes.

141. This means Master Trusts must spend time and money ensuring compliance with ERI restrictions. To ensure compliance, schemes need to monitor any changes to the governance, operations and ownership of companies that could relate to the scheme’s participating employers against the underlying holdings of the scheme. Again, when there are only a small number of companies and

associates connected to the scheme, this is a negligible cost but with thousands of employers this can quickly escalate.

142. Another knock-on effect is that Master Trusts may be restricted in terms of asset classes in which they can invest. This includes private markets. Given that publicly listed debt is broadly exempt from the ban on employer-related loans, the ban itself does not severely restrict investment strategies in purely public markets. However, if a Master Trust wished to access private debt markets, it would have to ensure each and every one of the recipients of this private credit were not participating employers or associated with or connected to them.

143. Given that the Government has a wider objective of opening up all asset classes to DC schemes, most notably illiquids or private markets, we believe a change here should, make it easier for Master Trusts to access private credit markets.

144. That being said, another key Government objective for occupational pension schemes is continued member protection. In the context of ERI, the risk of undue influence from those "in charge of" the scheme remains an active concern. Therefore, we propose that trustees of Master Trusts will continue to be subject to limits on the extent to which they can invest in assets relating to the scheme funder, the scheme strategist, and any person associated with or connected to the scheme funder or scheme strategist.

Question 10: Do you think the current regulations relating to ERI in the 2005 Regulations present a barrier to Master Trusts expanding investment strategies to include private debt/credit?

Proposed changes to regulations

145. Our proposed changes would amend:

- The Occupational Pension Schemes (Investment) Regulations 2005
- The Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations 1996
- The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013
- The Application of Pension Legislation to the National Employment Savings Trust Corporation Regulation 2010

146. In the 2005 Regulations we propose to include a new regulation 16A, which will apply specifically to authorised Master Trusts (as defined in the 2017 Act) with 500 or more active employers.

147. This new regulation will amend the definition of ERI for these schemes so that restrictions on ERI will only apply in relation to investment in the scheme funder,

the scheme strategist, or a person who is connected with or an associate of the scheme funder or the scheme strategist.

148. We have considered the data provided by TPR regarding the number of participating employers, assets, and members for the 36 Master Trusts currently listed as authorised Master Trusts when determining an appropriate figure to set the threshold for when this new regulation should apply.

149. TPR's data indicates that 13 authorised Master Trusts will be in scope with 500 plus participating employers[25]. The data suggests there is a considerable gap between those Master Trusts with 500 or more participating employers and those that fall below that figure making this a sensible place to set a threshold to avoid schemes falling in and out of the scope of this amendment.

150. We have also taken into consideration the fact that the cost of monitoring ERI breaches increases the greater the number of participating employers there are in a scheme and the cost of monitoring less than 500 participating employers is manageable.

151. We believe the risks of a single employer having influence over the investment approach increases the smaller the number of participating employers there are in a Master Trust scheme and diminishes the greater the number of participating employers. We believe 500 is the appropriate threshold beyond which that risk dissipates to a negligible level.

152. We have included a 2-year transitional period should the number of active participating employers drop below the 500 threshold, before the Master Trust is no longer in scope of this amendment.

153. Similarly, if a Master Trust experiences a 'trigger event' which leads to the Master Trust scheme losing its authorisation status, then the trustees have 2 years from the date its authorisation is withdrawn in which to divest from any investments in order to bring the scheme within existing ERI limits.

154. If the new regulation ceases to apply to a scheme, but divestment from any employer-related investments could not be achieved before it ceased to apply, for contractual or other legal reasons, then the trustees may retain those investments until the earliest date on which they are able to disinvest.

155. We propose amending the Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 to reflect the amended ERI requirements for large Master Trusts.

[25] Data from The Pensions Regulator.

156. Similarly, we propose amending the Occupational and Personal Pensions (Disclosure of Information) Regulations 2013, so that the disclosure obligation on large Master Trusts reflect the amended ERI requirements that apply to them.

157. We also propose to amend the Application of Pension Legislation to the National Employment Savings Trust Corporation Regulations 2010, because we envisage that the proposed amendment will apply to the National Employment Savings Trust Corporation (NEST), meaning that the exception from ERI set out in those regulations is no longer necessary.

Commentary on proposed draft regulations

158. The following summary explains the purpose of each of the provisions.

Regulation 1 – Citation, extent and commencement

159. This is a general regulation which gives the title of the regulation and specifies the date on which the regulations come into force.

160. It is proposed that the regulations will come into force on 1 October 2022.

Regulation 2 – Occupational Pension Schemes (Investment) Regulations 2005

161. This regulation amends the Occupational Pension Schemes (Investment) Regulations 2005, so that the restrictions on employer-related investments by large Master Trusts only apply to investments relating to the scheme funder, the scheme strategist and persons connected to or associated with the scheme funder or the scheme strategist.

162. Regulation 2(1) to (4) inserts cross-references into the existing ERI provisions in the 2005 Regulations which are required as a consequence of the introduction of the new regulations 16A and 16B.

163. Paragraph (5) inserts new regulations 16A and 16B into the 2005 Regulations, which set out the new requirements for authorised Master Trust schemes.

164. Paragraph (1) of new regulation 16A describes the Master Trusts to which new regulation 16A applies, namely authorised Master Trust schemes in which the number of participating employers in the scheme is 500 or more. It is only intended that participating employers of active scheme members are taken into account, for the purposes of determining whether the scheme meets the 500 threshold.

165. Paragraphs (2) and (3) of new regulation 16A provide details of the transitional arrangements that apply should the number of participating employers fall below the 500 threshold or should a Master Trust lose its authorisation. This is intended to prevent the circumstances in which a scheme falls temporarily under 500 participating employers for a month, for example, having to comply with a separate set of regulations for that month. It is also intended to give schemes the

opportunity to review their investments, where they are likely to stop meeting the conditions for the new regulation to apply to them.

166. Paragraph (4) sets out a new definition of ERI, for the purposes of determining whether large authorised Master Trust schemes are within the ERI limits prescribed in regulation 12(2).

167. It mirrors the definition of employer-related investments that currently apply under the 2005 Regulations, save that it only includes investments relating to the 'scheme funder or the scheme strategist' or persons connected or associated with them.

168. Paragraph (5) provides details of what constitutes an employer-related loan for large Master Trusts and makes clear that it will only include loans to the scheme funder, scheme strategist or persons connected or associated with them.

169. Paragraph (6) exempts transactions at an undervalue with participating employers of large Master Trusts (other than the scheme funder, scheme strategist or persons connected or associated with them) from the restrictions set out in Regulation 12(3).

170. Paragraph (7) makes a consequential change to the list of investments to which ERI restrictions do not apply, to reflect the new requirements for large Master Trusts.

171. Paragraph (8) removes the 20% cap on employer-related investments for large Master Trusts. Given the ERI definition is only met by an investment in the scheme funder or the scheme strategist (or persons connected or associated with them), and, as such, the 5% ERI limit is only likely to apply in relation to a small number of employers, we believe that having a 20% limit on all ERI across all relevant employers is unnecessary.

172. Paragraphs (9) and (10) maintain the existing transitional arrangement in the 2005 regulations that applies when an investment becomes employer-related; for example, this could be when a new employer becomes a sponsor or strategist for the scheme. Schemes will have two years to divest from such investments or they must do so by the earliest date possible.

173. Paragraph (11) provides that for a Master Trust hybrid scheme in scope (i.e. a scheme that provides both DC and DB benefits), new regulation 16A only applies to the defined contribution part of that scheme.

174. Paragraph (12) defines 'employer', 'money purchase benefits', scheme funder', 'scheme strategist' and 'securities' for the purposes of new regulation 16A.

175. New regulation 16B provides transitional protection for a scheme that ceases to be covered by new regulation 16A, but is unable to immediately repay or divest from an employer-related investment, for contractual or other legal reasons. The scheme may retain the investment until the earliest date on which it can effect repayment or divestment.

Regulation 3 – Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations 1996

176. Regulation 3 amends the Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 to reflect the changes made to the ERI regime for large Master Trusts.

Regulation 4 – Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013

177. Similarly, regulation 4 is a consequential amendment to the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 to reflect the changes made to the ERI regime for large Master Trusts.

Regulation 5 – Application of Pension Legislation to the National Employment Savings Trust Corporation Regulations 2010

178. Regulation 5 is a consequential amendment to the Application of Pension Legislation to the National Employment Savings Trust Corporation Regulations 2010 to remove provisions which are no longer needed as a result of the proposed new ERI regime for large Master Trusts.

Question 11: Do the draft regulations achieve our policy intent?

Costs and Benefits

179. A draft impact assessment considering the direct and indirect financial impacts on business and on others has been published alongside this consultation.

180. The counterfactual is the 'do nothing' scenario in which existing ERI regulations would continue to apply unchanged, all schemes must spend time monitoring each investment and face barriers to where they can invest.

181. We expect specified schemes in scope may experience benefits from the amendment of ERI restrictions including a cost saving from the reduction of administrative tasks and reporting requirements and more resource directed to other projects or innovations which have not been pursued due to the time spent on ERI activities. These may be beneficial to both schemes and members.

182. We would welcome any evidenced comments on the impact assessment. Specifically, we would welcome views on:

- Our assumption on the number of trustees per scheme in scope for familiarisation.
- Our assumption on the fewer hours spent per month on the administrative and reporting tasks associated with ERI.

Question 12: Do you agree with the information presented in the impact assessment?

Chapter 4: Future of the defined contribution pensions market: The case for greater consolidation

Background

183. From 21 June to 30 July 2021, DWP ran a call for evidence entitled 'Future of the defined contribution (DC) pension market: the case for greater consolidation'[26]. This was a continuation of the government's efforts over recent years to drive value for members outcomes, ensuring DC schemes deliver good governance and target best possible performance returns, and where they do not ask that schemes consider winding up and consolidating their members into better performing schemes.

184. The call for evidence built on the new value for member assessment requirements for smaller DC schemes with under £100million in assets recently introduced, that challenge those schemes to prove they offer comparable value to larger schemes, and signaled for the first time the government's ambition to look next at how to drive consolidation further and faster for schemes above £100million in assets.

185. We wanted to explore if any approaches from international examples, such as in Australia, where scale has been the biggest driver in achieving value for money for savers could be learned, and how government and the industry might work to better incentivise consolidation across the DC market further. What follows is a summary of the responses we received.

Overview of stakeholder responses

186. DWP proposes that the benefits of consolidation range from improved governance standards, scheme efficiencies and greater investment opportunities resulting from economies of scale. However, we do acknowledge that bigger is not always better for all members.

187. Overall, the evidence we received was mixed. Some stakeholders, supportive of the benefits of allocation to illiquid assets, believed that members of smaller schemes were suffering from a limited set of possible investment opportunities as a result of a narrow decision by the scheme's trustees to continue to offer a corporate scheme. Other stakeholders suggested that the proposed benefits of consolidation were in fact overstated and the costs and risks poorly understood as well as the benefits of corporate schemes.

[26] https://www.gov.uk/government/consultations/future-of-the-defined-contribution-pension-market-the-case-for-greater-consolidation/future-of-the-defined-contribution-pension-market-the-case-for-greater-consolidation

188. Many respondents highlight a disruption within the market if consolidation is forced too quickly. The consensus was for government to slow down the process to ensure better member outcomes are being achieved. It was recommended DWP should wait to see the impact of the new value for member assessments undertaken by small schemes before embarking on new policy ideas that might apply to schemes above £100million.

Stakeholder responses to Call for Evidence questions

> **Question 1:** Do you agree that the government is right to aim for fewer, larger schemes going forward? Are there any risks?

189. Many respondents reacted positively to the prospect of greater consolidation within the DC market leading to fewer, larger schemes. We received comments to the effect that larger schemes have the potential to drive better outcomes for members, such as, offering higher standards of governance, quality in service delivery, lower charges, and with economies of scale wider ranging investment opportunities.

"Fewer larger schemes should mean members benefit from scale, more effective governance and greater options for investments. More members will be in modern, future-proofed schemes, which can support them to and through retirement." **Scottish Widows**

190. Nearly all respondents noted how important it was that consolidation should only be pursed if it results in improving outcomes for all members. That there should not be a presumption that consolidation should happen based on size alone was firmly rejected.

"We agree that the government is right to aim for fewer, larger schemes going forward. It is vital that any measures proposed are done so with the goal of enhancing protection, value and outcomes for members through the consolidation process. Failure to do so would be a missed opportunity." **HSBC**

191. Expanding on this, respondents believed that schemes of all sizes can deliver excellent outcomes, and where schemes irrespective of their size, can demonstrate value there is no reason why they should be forced to relinquish their position in the market.

"DWP is right to aim for fewer, larger schemes in the future, so long as this push is accompanied by regulatory guardrails on components of member value. To that end, we would stress that greater scale does not guarantee improved member outcomes or better value for money. By the same token, smaller schemes can be run well and provide value even if doing so may be more difficult than for larger schemes." **Nest**

192. A few respondents questioned the merit in targeting consolidation for larger schemes who were very probably delivering very good outcomes for their members already. It was suggested that increasing the threshold of schemes where regulatory action might be taken to encourage consolidation needed careful consideration.

“We think the £5bn upper threshold being discussed is far too high and that schemes significantly beneath that asset size can and do provide good outcomes for members.” **Lane Clark Peacock**

193. Nearly all respondents called for patience to any government ambitions to achieve mass scale consolidation. Several respondents stated that the average scale of DC schemes is already increasing as the market matures, due to automatic enrolment and consolidation being taking forward naturally in the interest of members.

“We do not believe the value for member assessment will significantly increase the rate of consolidation than the baseline trend we have already seen. This is at least in part because the trend to consolidation has already been so significant in the past ten years.” **Pensions & Lifetime Savings Association**

194. Some respondents expressed concern that forcing too much consolidation too soon onto the market, before it can cope with this demand, could lead to unintended consequences, such as distorting competition and destabilising the market.

“There is no upside in forcing the pace of consolidation to the point that it outstrips the capacity of the market to offer high quality services. There is also a balance to be struck between consolidation and fewer schemes and choice.” **Mercer**

195. Some respondents forewarned that a focus on asset size and a rush to increase consolidation to only a handful of super large schemes could have consequences, such as, a potential stifling of competition in the DC market, which could result in a greater preoccupation on costs over value return and innovative investment strategies. Respondents also commented that it might see wider economic consequences such as considerable job losses within the sector or risk of a systematic financial collapse as has taken place in other sectors.

“The creation of mega schemes will have a wider impact on the pensions industry. The existence of only a few schemes limits the amount of service provision required to operate the industry. Providers such as auditors, legal advisors, actuaries, investment, and benefit consultants would see their client base stripped to a minimum.” **Evolve**

196. Respondents highlighted explicit examples of the benefit of maintaining a market that contains single-employer corporates and multi-employer Master Trusts. Namely, some reported that contributions could well be higher in the corporate schemes and that charges may well be lower (or at least less directly member-borne).

“There is a significant risk that value for money could worsen as a result of members being asked to pick up the administration cost post consolidation.” **Buck**

Question 2: What impact will the new value for members assessment have on consolidation of schemes under £100m?

If you were a scheme that did not pass the value for members assessment, would you look to “wind up” or “look to improve” and how would you go about this?

Beyond the value for money assessment, could government, regulators and industry accelerate the pace of consolidation for schemes under £100million?

197. Nearly all respondents agreed that where smaller schemes failed to demonstrate value in comparison with what members receive in larger schemes, then the government is right in its approach to continue to nudge those smaller schemes to consider transferring their members into a better performing large scheme.

“Where there are schemes that are poorly governed and failing to deliver value for members, it is right that regulation should support the drive to consolidation.” **Creative**

198. Respondents were largely divided as to whether trustees that had completed and effectively failed the value for members assessment, would follow through with actions to wind up the scheme and transfer members out. Of the respondents that believed action would be taken, most pointed to the cost burden of the annual assessment as a driving force in accelerating decisions by trustees and particularly employers towards consolidation at a quicker pace than planned.

“Any schemes under £100m in size will find that they lack the resources to effectively adopt the new value for member assessment and this supports the desired policy outcome to accelerate the pace of consolidation for schemes under £100m.” **Hymans Robertson**

199. A few respondents commented that from a reputational aspect, it would become increasingly difficult for those schemes that failed the assessment to justify to members their continued existence.

“Once word is out that trustees are managing a failing occupational scheme trustees can expect pressure not just from The Pensions Regulator but sponsor, members and unions to step down and wind up the scheme.” **Agewage**

200. Other respondents were more indifferent about the impact the value for member assessment might have on the decision of trustees to wind up the scheme and consolidate. They highlighted that as the test was in effect a self-review led by trustees themselves then there is a danger of subjectivity creeping in that would support the trustee continuing in their role.

"No matter how objective the assessor tries to be, there is likely to be an unconscious bias in favor of a positive assessment of the scheme's governance. If the DWP wishes to increase the number of schemes failing the value for member assessment, an easy step would be to promote or require an independent objective assessment." **LawDeb**

201. A few respondents said they believed the value for member assessment would have limited impact as some trustees will view these as another regulatory obstacle to overcome; particularly given it is one that does not come with a legal obligation to wind down the scheme.

"The new value for member assessment will have a limited impact on the consolidation of schemes under £100m as many will see it as a box ticking exercise." **Natwest**

202. Other responses pointed out that for some trustees and employers, the assessment may lead to a conclusion that the scheme can still deliver better outcomes for members than a consolidator if appropriate changes are made. Therefore, the expectation was that we could see many schemes follow the "look to improve" route in the belief that this is in the best interests of members.

"Taken as a binary consideration, many schemes would "look to improve" rather than "wind up". In those instances, the government must satisfy itself that the smaller schemes do indeed have the resources to make meaningful and sustainable changes and which deliver tangible benefits to members." **HSBC**

203. Some respondents believed we were right to highlight the common difference of opinion that may occur between the trustee and employer over a decision of what best to do in the event of a failed assessment. Some said that whereas the trustee's instinct may be to improve the scheme, the employer may be more inclined to wind up and transfer members out. Conversely, the trustees may recommend wind-up, but an overly paternalistic employer may wish to 'keep their name on the door'.

"Our expectation is that most trustees of schemes that do not pass the value for member assessment will initially look to improve before winding up. Though we believe many employers will prefer consolidation, given the benefits to them of a reduction in benefit spend and regulatory risk and burden." **Society of Pensions Professionals**

204. Many respondents commented that the decision on whether to wind up or look to carry on a scheme with improvements lies squarely with cost. In that the up-front costs of winding up the scheme would normally be greater than the cost of undertaking remedial work.

"Some trustees will take action, but some will be reluctant to change even with a low value for money score due to wind up costs and the time it takes to transition." **Buck**

205. In terms of further action to speed up consolidation for sub £100million schemes, respondents drew attention to the role TPR could have in taking action against schemes which are badly governed and/or have weak employer support.

"The rump of recalcitrant schemes will argue that they are looking to improve but The Pensions Regulator will need to be firm in its approach and use its powers to force wind-up where the improvement plan does not look plausible." **Agewage**

Question 3: How can government incentivise schemes with assets of between £100million - £5billion to consolidate?

206. Most responses we received reacted unfavorably to the principle of phase two consolidation stating that the government should not be focusing its efforts at this time on policy proposals aimed at consolidation of schemes above £100million which are likely to be already well-performing schemes delivering value to their members.

"We do not think that good schemes that satisfy value for members should be arbitrarily pushed into consolidation just because of their size." **Capita**

207. Many respondents commented that the pace with which consolidation of the market is being pursued by government is too rapid and unsustainable. Many argued for patience as consolidation is already taking place naturally in the industry, and to enable Master Trusts to grow in size, and capability. This included reference to a very interesting piece of research by Willis Towers Watson that captures the attitudinal shift that has occurred in recent years.

"A recent survey by Willis Towers Watson of employers running their own scheme suggested that 61% were considering a shift to master trusts. A patient approach to consolidation may see the goals of this paper achieved in just a few years without any further intervention." **Creative**

208. Most respondents reiterated the point that DWP should wait and assess the impact of the value for member assessments for smaller schemes before considering any further policy options aimed at schemes above £100million. Several respondents suggested a review of this at a suitable time would show the success of the policy in terms of closing schemes and tracking members to see whether improved outcomes were received because of that transfer.

"We strongly believe before government considers pushing ahead with 2nd phase of consolidation agenda, it should give time for the 1st phase to bed in. This will provide insight into the consolidation process and the benefits and possible risks to members." **Aegon**

209. Despite most cautioning against further rollout of the value for members assessments, some respondents suggested the value for member assessment should or could be extended to cover schemes above £100million.

"Government may wish to increase the £100million threshold for the more detailed value for member assessments after it has seen how successful the new measures have been for smaller schemes." **Willis Towers Watson**

210. It was further highlighted that to assess whether there's an advantage in consolidating, employers and trustees will need to consider whether there are likely to be better member outcomes in moving to a Master Trust and that the government could support this by making the Master Trust market competitive and therefore improving the attractiveness of the Master Trust offer.

"The most important incentive is to promote a competitive Master Trust market. Through competition, Master Trusts will innovate towards market leading solutions for members, delivered at optimal cost." **Hymans Robertson**

211. We received suggestions that the government would need to address barriers that larger pension firms face in terms of consolidating schemes, for example, bulk transfers, where members may have generous guarantees attached, or come with a large number that add a significant administration burden.

"Breaking down or removing the barriers to consolidation for those schemes with complex benefit structures who would otherwise consolidate would be helpful. In most cases, these underpins can severely hamper members too as it prevents trustees transferring members to arrangements which are better governed, have lower charges and offer members greater flexibility." **Gowling**

212. There were also suggestions that government could potentially provide financial incentives to cover the costs of transaction or wind-up, which was cited as one of the biggest barriers currently preventing schemes from choosing to consolidate.

"The government should consider whether it would be appropriate for grants to be made available to cover some of the cost of wind-up. This would be particularly helpful in cases where the sponsoring employer is no longer around." **Scottish Widows**

"In our experience of working with own trust clients, two of the main barriers to clients consolidating are time and the potential transaction costs. The work involved in communicating to members, managing project work streams, selecting providers is significant and this is assuming that the administration records are of sufficient quality to be able to transfer." **Phoenix**

213. Other suggestions included TPR prioritising wind up of schemes that were failing to meet governance standards, and the government to look more widely at reducing current regulatory burdens on trustees that would then free up more time for trustees to pursue consolidation options.

Question 4: Assuming a scheme wishes to consolidate, how significant are the barriers identified above? Are there others? How do barriers vary for medium-larger schemes?

How can the government, regulators and industry remove these barriers?

How can government incentivise consolidation for schemes between £100million and £5billion especially where there may be a proportion of members who have smaller pots and therefore may be less attractive to receiving schemes? Could government incentivise trustees of both the merging and receiving schemes to take a mixed economy of smaller and larger pots or could this be provided by the market at a suitable cost, and without imposing additional cost consequences on members?

214. Respondents overall agreed with the barriers listed in the call for evidence are real or perceived barriers to consolidation with trustees more likely as a result to adopt an overly risk-averse approach in ceding members to another scheme, in case there is a chance that they might not be better off.

"The barriers identified cover most of the bases and they are all significant and will vary on a case-by-case basis, depending on the views and attitudes of both the ceding and receiving scheme." **Smart Pensions**

215. The consensus view was that older smaller schemes are not likely to have many choices to consolidate, as larger schemes will see them as economically unviable or transactionally complex.

"The size of scheme and the future proposals for employee benefits has allowed a greater flexibility in negotiate favourable terms but we can foresee that smaller schemes with a large number of low value members would not have such flexibility." **RBS**

216. It was also highlighted that larger schemes may sometimes be unwilling to take on members that come with a large number of small pots because of the time and the extra administration involved. Some responses pointed to further work needed to resolve small pots consolidation that if successful will relieve the administrative burden and save costs of consolidation, as the cost is dependent on the number of pots, rather than its value.

"A scheme with a low proportion of members with smaller pots is, generally, going to be more attractive to consolidators than one with a large proportion of such pots – too large a proportion of small pots can lead to a scheme becoming uneconomical." **M&G**

217. A few respondents said that Nest may offer a viable solution as a receiving scheme for both the lower value members and for small pots barriers described above.

"Perhaps there could be a scheme of last resort set up like Nest for automatic enrolment i.e. a scheme that could be used for consolidation where other providers won't take the assets for smaller schemes or smaller pots." **Buck**

218. Some respondents highlighted that the time and cost of transition involved in a transfer of members to a new scheme can in many cases act as a real barrier that needed addressing if more schemes are going to be encouraged to consider consolidation as a more attractive proposition.

"The cost of any changes (for scheme closure/wind up activity, member communications and changes to infrastructure such as payroll, HR systems, governance) would be significant, time-consuming and resource intensive and it's not clear that there would be any return on this investment in the form of savings to the employer." **Lloyds Banking Group**

219. Other potential barriers identified to consolidation to many schemes irrespective of size, were the ability to transfer members that come with tax protections or built-in guarantees. It was suggested that benefits lost on transfer more often was a disincentive to trustees pursuing the case for a transfer of members from a single employer scheme to a Master Trust.

"We don't expect many receiving schemes will seek to preserve or replicate guarantees and resolving them in other ways is complicated and expensive. Therefore, in many cases it is a question of whether the guarantee is more valuable than the potential benefits of the more modern scheme." **Scottish Widows**

220. Even with barriers listed some respondents said that none of these were in a way insurmountable to preventing consolidation occurring, as consolidation is happening already in the market.

"There are legacy factors such as with-profits, GAR and money purchase underpins that will require some unravelling. But these should not be a barrier for most schemes to switch." **AgeWage**

Question 5: How can we mitigate any risks associated with scheme consolidation?

221. Many respondents said that there were few risks associated with scheme consolidation pointing to the Master Trust authorisation process which should provide confidence to employers/trustees.

"Moving to an authorised Master Trust should, on the whole, deliver better outcomes for members across the piece through better communications, governance and investment. From a member's perspective there is actually a greater risk of not doing anything and having members languishing in poorly run and governed schemes." **Smart Pensions**

222. Many respondents however did caution that forcing schemes to consolidate too quickly carried the greatest risk, as sufficient time was needed to ensure larger schemes, including Master Trusts had the requisite governance and infrastructure in place to be able to take on many more schemes and members.

"The best way to mitigate any risks associated with scheme consolidation is to avoid putting too much pressure on trustees and the pension industry to accelerate the pace of consolidation. The risk of getting it wrong and choosing the wrong consolidator or rushing implementation could be detrimental to members' outcomes." **Aegon**

223. Respondents also said there was an onus on trustees to ensure they were carrying out full due diligence, including a thorough cost benefit analysis when considering options for moving members to a new scheme. Furthermore, that the assessment needed to ensure members would be receiving better value from any transfer.

"All schemes will need to undertake a full cost analysis before any decision is taken to transfer, to ensure that the impact of transaction costs is fully understood by the Trustees and their advisers." **Phoenix**

224. Several respondents drew attention to the potential risk to members of consolidation if it is undertaken at an unhealthy pace or is ultimately driven towards schemes that may not consider overall value, focusing instead on price.

"Member experiences may be negatively impacted by increasing the pace of consolidation unnaturally, at worst through errors or mistakes that lost members money and require compensation. There are also other compromises that consolidator schemes may have to make in haste and deliver at speed, such as communications approaches that are less tailored and more generic." **Pensions & Lifetime Savings Association**

"Government needs to ensure that Master Trusts are incentivised to innovate, which is more likely to happen if focus switches from charges to value; a narrative already being changed by the new value assessment, but which could be advocated further. This should ensure there isn't a race to the bottom on fees, to the detriment of the offering as a whole." **Sackers**

225. Some respondents called on guidance to help trustees better prepare and navigate the path to consolidation. Potentially this would need to cover the costs and include best practice case studies of how this has been done as a way of incentivising trustees and employers to choose this route.

"Ultimately trustees need to ensure that any consolidation is in the members' best financial interests. These principles must underpin any regulation, guidance etc. issued by the government on the consolidation process." **Gowling**

Question 6: What other international good practice exists?

226. Several respondents highlighted attempts to try and replicate a consolidation model for the UK DC pension system with what has been achieved in other countries like the Australian superannuation model needed to be viewed in the context of how each has evolved over time, and of the different approaches taken to achieve different outcomes. In this sense it would be difficult to replicate like for like without wholesale changes in the way the UK pension system currently works.

"The UK and Australian pension regulatory environments are very different and are not directly comparable e.g. Australian system does not have the same protections in place as the UK, such as the charge cap. Compulsory contributions are higher in Australia, and employees can select their own pension scheme, rather than the employer." **Aegon**

227. However, respondents also suggested there were plenty of lessons and practices to be learnt from approaches taken in Australia as well as other countries that the UK DC model might think about trying to replicate where appropriate.

"Moving fully to that [Australian] model would be a radical change for the UK pensions market and maybe prohibitively expensive, however, we do think that lessons can be learned. In particular, increasing the scope for individuals to select their own pension arrangement rather than be defaulted into the employer's arrangement may be beneficial." **Hymans Robertson**

228. Similarly, the point was made that there may be more to learn from international experience in terms of investment strategy rather than the efficient maintenance and governance of UK DC schemes.

"There is much to be learned from US safe-harbour legislation and that it could be used in the UK to protect sponsors and trustees from problems down the line of a failure of the consolidator." **AgeWage**

229. Some respondents argued that the UK pension system is recognised as one of the best developed and sophisticated models internationally, and therefore attempts to try to emulate what has been achieved elsewhere may risk undoing its success.

"We believe the UK pension market is considerably more developed with legacy issues than virtually all other countries. Therefore, we feel that there are few, if any directly comparable countries." **Lane Clark Peacock**

Question 7: How important is scheme consolidation in driving better member outcomes?

What more can government and industry do to move away from a narrow focus on low costs and charges to a broader assessment of value for money that encompasses investment strategies whether innovative or otherwise and overall net returns?

230. Many respondents agreed that consolidation was directly linked to improving member outcomes and that further efforts to encourage greater consolidation in the DC space was welcomed.

“Consolidation should mean overall benefits from scale, better governance and the ability access a wider range of investments. It will also connect employers and member to more modern and future-proofed propositions.” **Scottish Widows**

231. There was general agreement from respondents that within the DC market keeping costs low is currently seen as more important than seeking value through investment. Most believed that this was the greatest limit on achieving the best possible system with member outcomes at its heart.

“Regulation has encouraged a focus on fees and past performance. This is constraining innovation within schemes and leading to bland uniform investment solutions.” **Willis Towers Watson**

232. Most respondents agreed the new regulatory measures that came in last October requiring schemes to report their net investment (performance) returns for the first time, would help to shift the narrative more to value gradually over time. The net returns metric may also have a positive effect in encouraging schemes to consider consolidation.

“We are encouraged by your aim to shift the discussion on value away from ‘the cheapest’ to one that looks at a broader range of factors. There is a tendency for trustees and their advisers to focus on charges to the detriment of other metrics.” **Legal & General**

“The market is overly fixed on cost aspects when selecting a scheme to consolidate into and does not pay enough attention to net investment returns, which have a much more material impact on member outcomes.” **Aon**

233. There were some respondents that said that consolidation would be helped by the development of more holistic value for member assessments or frameworks that would enable trustees and schemes to compare more easily. Several pointed to the work being led by the FCA and TPR in this area.

“Instead of measuring charges and net investment returns – which are often hard for a member to understand and are not always easily comparable, we would

advocate a more holistic approach focussing on the adequacy of expected outcomes.” **Mercer**

Question 8: How can government, regulators and industry incentivise scheme consolidation?

234. The call for evidence posed this open question to allow respondents the opportunity to provide suggestions for what they think the government could do in order to incentivise scheme consolidation. However, as the question was similar to Question 3, many responses chose to refer us back to the answers they had previously given here.

Question 9: Is there anything else, not covered in the other questions, that the government should consider?

235. A few respondents made the point that consolidation into fewer larger schemes may not realise the government’s ambitions for greater investment to illiquid assets. It was pointed out that often large single employer trusts and less commercially focused Master Trusts are more likely to invest in these products over commercial Master Trusts that are likely to want to keep costs as low as possible in order to compete with one another for business.

“Trustees will take decisions on investment strategies on the best interest of members, regardless of their size. The government has not provided evidence that smaller schemes are more likely to choose to invest with disregard for their members’ best interest. Moreover, large schemes can also be guilty of highly commoditised, mainstream liquid asset classes or otherwise ‘uninspiring’ investment options, too.” **Pensions & Lifetime Savings Association**

236. Several respondents commented that automatic enrolment contribution rates were in their opinion too low and that attempts to raise them should be a focus going forward.

“Government should consider an increase on the minimum total contributions required under Auto Enrolment. We would suggest an increase in the short to medium term of +50% to centre total contributions at around 12% of pay.” **Natwest**

237. There was a general sentiment among many respondents that government should step back from consolidation and consider other priorities for the DC sector, such as, the pensions dashboards and small pots solutions first. It was

suggested for both that efficient resolution would likely lead to an increase in member engagement in their retirement savings.

"Further, consolidation of small pots is something that is being considered via other government routes. We believe that consolidation of these is beneficial to members and should be progressed." **XPS**

238. There were also calls for closer alignment between DWP, TPR and the FCA to ensure consistency in approach between trust and contract-based schemes.

"Given the ongoing strategic alignment of FCA and TPR, it would be appropriate that where possible, changes are implemented across the board to ensure members are provided with same protections and opportunities". **TISA**

Government response

239. We have taken all comments and suggestions into account and thank respondents for one of the most fruitful calls for evidence we have run recently.

240. The government remains concerned that members are suffering in poorly performing schemes, unable to access the full range of available investments, subject to higher than necessary charges, and generally poorer governance. However, we have faith that ongoing interventions and proactive trustees will ensure that members are the primary and only consideration when deciding the fate of a pension scheme.

241. We are also encouraged by the data published by TPR, which suggested consolidation is continuing to take place at a healthy pace of year-on-year decline in the number of schemes[27].

242. We will therefore not be introducing any new regulatory requirements with the sole purpose of consolidating the market in 2022. However, we will work closely with TPR to monitor the impact of the value for members' assessment, which will start to be produced this year.

243. Our focus will continue to be on creating, with TPR and the FCA, a value for money framework for occupational and workplace pension schemes. Building on the work already done, considering responses to the discussion paper issued by TPR and the FCA, DWP will work with regulators to create a framework that brings about consistent, informative, member-focussed value metrics that will enable comparison and encourage competition on overall value. We believe this will improve member outcomes more so than targeted consolidation measures.

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[27] DC trust: scheme return data 2021 to 2022 | The Pensions Regulator

Annex A: List of respondents to 'Enabling Investment in Productive Finance'

Abrdn
ABI (Association of British Insurers)
ACA (Association of Consulting Actuaries)
Aegon
Age UK
AIC (Association of Investment Companies)
AIMA
Aon
Apex Group
Association of Pension Lawyers
Association of Real Estate Funds
Aviva
Barnett Waddingham
BCF Pension Trust
B&CE
BGF
BIA
Blackrock
BVCA
CBI
Creative
Hymans Robertson
IPF
Investment Association
Isio Group
J.P. Morgan Asset Management

LCP (Lane Clark Peacock)
Legal & General
Macquarie Asset Management
Mercer
M&G PLC
Octopus Group
Partners Group
Pinsent Masons
PLSA
PPI (Pensions Policy Institute)
Railpen
Octopus Group
Scottish Widows
Simmons & Simmons LLP
Smart Pensions
SPP (Society of Pension Professionals)
Tesco
TechUK
TISA (The Investing and Saving Alliance)
Transparency Task Force
TUC
UKSA & ShareSoc
USS
Willis Towers Watson
Individual responses - 5

Annex B: Draft Regulations

[Draft Regulations: The Occupational Pension Schemes (Investment) (Employer-related investments by Master Trusts) (Amendment) Regulations 2022]

Annex C: List of respondents to 'Future of the defined contribution (DC) pension market: the case for greater consolidation'

ABI (Association of British Insurers)
ACA (Association of Consulting Actuaries)
Agewage
Aegon
Aon
Association of Pension Lawyers
Aviva
BCF Pension Trust
Buck
Capita
Creative Benefits
Cushon
Evolve Pension
Gowling WLG
ILAG
Isio Group
LCP (Lane Clark Peacock)

LawDeb
Legal & General
Lloyds Banking Group
M&G PLC
Make My Money Matter
Mercer
Natwest
Nest
NextGen
NOW Pensions
PASA (Pensions Administration Standards Association)
Pearson
PPI (Pensions Policy Institute)
PLSA
Sackers
Scottish Windows
SEIC
Smart Pensions
Standard Life
Syngenta
The People’s Pension
The SPP (Society of Pension Professionals)
TISA (The Investing and Saving Alliance)
Willis Towers Watson
XPS Pensions