HM Treasury | Department for Work & Pensions | Ministry of Housing, Communities & Local Government

Pensions Investment Review

Interim Report

November 2024

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Ministerial Foreword

The UK's world leading £3 trillion pensions industry has the third largest stock of pension assets in the world. The foremost purpose of these assets is and will always be to provide security in retirement. That is why as part of this Review we have looked at how to increase saver returns and tackle waste in the pensions system. They have also historically played a second important role as a major source of domestic investment. Investment is vital to help achieve growth, which is the number one mission of this government, and pension scheme funds have a role to play in that.

Our Manifesto set out that we will adopt reforms to ensure that workplace pension schemes take advantage of scale and consolidation, to deliver greater investment in UK productive assets and better returns for UK savers. This Interim Report starts to set out our long-term vision for a defined contribution pensions system with fewer, larger and less fragmented schemes that are more able to invest for the longer term and in the UK, and that can boost returns for UK savers.

It is essential that we start setting out our vision now, in time for the upcoming Pension Schemes Bill, for a new and potentially simplified system rather than make piecemeal reforms over time. This vision will give industry the clarity and certainty it needs to plan for the future.

The same approach applies to the £392bn Local Government Pension Scheme in England and Wales (LGPS). This Interim Report sets out a consistent and sustainable approach to ensure the investment potential, from a consolidated LGPS, is fully realised. The Minister for Local Government is jointly leading this aspect of the Review and is bringing forward a consultation on these proposals following extensive engagement with LGPS stakeholders.

The Call for Evidence received over 200 responses, and throughout the preparation of this report the contribution of firms, representative bodies, individual experts, local government and wider industry stakeholders has been exceptional. We want to thank them for their input and time. Though this is only the Interim Report, the expertise and insight gathered has been integral in the development of the Review so far.

Together, with major programmes to unlock the potential of the UK economy such as planning reform, the modern industrial strategy and the National Wealth Fund, these proposed reforms have the potential to boost UK growth and improve pension saver outcomes.

Emma Reynolds MP

Minister for Pensions

The Local Government Pension Scheme exists to provide financial security and dignity in retirement for its 6.7 million members, who have dedicated their working lives to serving local communities. With an asset value of £392 billion, the scheme is one of the largest in the world and the largest funded pension scheme in the UK. The Pensions Review has been looking at how we can strengthen the LGPS to harness its full investment potential as an engine of UK and local growth, and ensure that in delivering for its members it also delivers all it can for their communities.

This report and the accompanying consultation set out a pathway to a reformed LGPS that has been informed through extensive engagement with LGPS stakeholders over recent weeks. We have been struck in those conversations by the good work that LGPS administering authorities and pools are already doing to consolidate assets, collaborate, and to support their local communities. The LGPS is leading the way in investing in UK assets and, in some cases, already provides a blueprint for how excellence in pensions investment can result from prioritising scale, strong governance and capability, and this has earned the sector a commendable reputation which we are keen to champion. However, it has also been clear that progress is not equal everywhere and that reform is needed if we are to realise our vision of the LGPS as a world-leading exemplar of best practice in pensions investment and governance.

My vision for the LGPS is that it plays a significant part of the government's growth mission, sitting alongside our major programmes to rebuild Britain's infrastructure and boost the supply of investible opportunities in the UK. In particular, we want to see the LGPS working closely with Mayoral Combined Authorities alongside Local Authorities to identify and develop investable opportunities appropriate for pensions investment.

I look forward to continuing the conversation with stakeholders over the coming months as we finalise our proposals.

Jim McMahon MP

Minister for Local Government

Introduction

The Labour Manifesto committed the government to undertake a review of the pensions landscape to consider what further steps are needed to improve pension outcomes and increase investment in UK markets.

The Labour Manifesto also committed that the government adopt reforms to ensure that workplace pension schemes take advantage of consolidation and scale, to deliver better returns for UK savers and greater investment for UK PLC.

On 20 July 2024 the Chancellor launched Phase One of the Pensions Review: the Pensions Investment Review, as led by the Joint Minister for Pensions working closely with the Minister for Local Government.

The terms of reference for phase one were published on 16 August 2024. These note the scope of the report being limited to defined contribution workplace schemes and the Local Government Pension Scheme and set out the four areas of the policy remit of phase one. A Call for Evidence was also published on 4 September 2024, closing on 25 September 2024.

This is the Interim Report setting out the initial findings of phase one. A final report will be published in the Spring.

There are two consultations accompanying this report:

1. Unlocking the UK pensions market for growth; and
2. Local Government Pension Scheme in England and Wales: Fit for the future.

We are also publishing an analytical publication: Pension fund investment and the UK economy, looking at the historic investment trends of pension funds and international examples and the role of pension funds in economic growth.

An Interim Report and consultations have been produced to allow a full and thorough consultation process ahead of the Pension Schemes Bill which will be introduced next year. The final report will further consider domestic investment from pension funds.

The scope of Phase Two of the Review will be published in due course. It will broaden out the Review and consider further steps to improve pension outcomes, including assessing retirement adequacy.

Workstream 1

Scale and Consolidation in the Defined Contribution Workplace Market

1.1. The introduction of Automatic Enrolment (AE) has led to substantial growth in Defined Contribution (DC) pension schemes and the Master Trust (MT) market with the vast majority of savers within multi-employer arrangements; contract arrangements such as group personal pensions (GPPs) and trust-based arrangements. Most future asset growth is expected to be concentrated in these arrangements.

1.2. The responses to the Call for Evidence demonstrated wide support and agreement that scale leads to economies and efficiencies, as well as enabling greater expertise and diversification in investments. There is also clear evidence that larger consolidated schemes are more able to invest in more productive asset classes.

1.3. At present there remains, however, wide variation in member outcomes and limited diversity in how pension providers can and do invest. Many schemes are either not making use of scale, or are not of sufficient scale, to help seek better returns for members and to invest in productive assets, including in the UK.

1.4. The consultation paper, 'Pensions Investment Review: Unlocking the UK pensions market for growth' accompanying this report proposes measures designed to accelerate and help enable scale and consolidation in the DC market.

Achieving Scale and Reducing fragmentation

1.5. The government is clear that the future of the workplace DC market lies in fewer, bigger, better run schemes, with the scale and capability to invest in a wide range of asset classes, such as private equity and infrastructure, that can deliver better returns for savers long term and boost investment in the UK, which benefits savers and their communities.

1.6. The government recognises, and several respondents to the Call for Evidence acknowledged, that the DC workplace market is already consolidating. However, the reduction in the number of schemes has been most prominent for very small schemes. At the large end of the market, there is variation in size across both MTs and GPPs, and there can be fragmentation with GPPs often having many default arrangements[1] and default funds, meaning the average assets per default can be lower. This impacts the ability of schemes to invest into productive assets from these fragmented default funds.

1.7. Scale and consolidation among the larger schemes can therefore drive additional benefits. To help achieve this, we are seeking views on two proposals for multi-employer schemes - to introduce minimum size requirements for default funds and to place limits on the number of default funds.

1.8. We recognise that these are significant market changes and will not be achievable without a sufficient lead-in time. Careful consideration is required of the approach to implementation, for example, to ensure innovation is maintained in occupational pensions and that pension products meet the needs of all employers and employees.

1.9. We propose that such a requirement would not apply before 2030 at the earliest. The minimum size and maximum default numbers will be set following consultation, at a level at which these efficiencies, economies, and investment benefits are realised and that addresses the current fragmentation within the pensions system.

Facilitating the transfer of assets

1.10. We are also consulting on measures to enable the transfer of assets for contract-based schemes to either other contract- or trust-based schemes.

1.11. The Call for Evidence responses highlighted that a barrier to greater consolidation for contract-based workplace pensions is the requirement for providers to get individual consent before transferring savers from one arrangement to another.

1.12. To enable this, as well as allow for disengaged members to be transferred to better performing arrangements, and to establish equivalence with the trust-based DC market, we are proposing to legislate to allow contractual overrides without individual consent for contract-based pensions, with appropriate protections that would be set out in FCA rules.

1.13. This action will support the introduction of the upcoming Value for Money Framework and small pot default consolidators. Alongside this, there may be wider circumstances in which pensions arrangements may be considered as not delivering for its savers and it is therefore in the best interest of savers to transfer to a new arrangement. The detailed rules on the use of contractual override and transfer without consent would be developed by the FCA and consulted on in the usual way.

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1 2220922-the-dc-future-book-2022-final.pdf

Workstream 2

The Local Government Pension Scheme

2.1. The Local Government Pension Scheme in England and Wales (LGPS) is one of the world's largest funded pension schemes, managing the pensions of 6.7m members and investing £392bn worldwide, as at March 2024. Its scale makes it a significant investor with the potential to boost growth up and down the country, while delivering its core duty to make long-term stable returns to pay the pensions of those who have delivered vital local services.

2.2. The focus of the Review for the LGPS is to look at how tackling fragmentation and inefficiency can unlock the investment potential of the scheme, including through further consolidation. This is in the best interests of members, employers, local communities and the wider UK economy.

2.3. We are consulting on proposals to put the LGPS on a clearer, firmer long-term trajectory to scale and consolidation that has so far been suggested but not delivered, as well as measures to improve LGPS fund and pool governance and drive local investment. Together, these changes will put the scheme on the strongest possible footing for the future.

Consistent approach to asset pooling

2.4. Since 2015, the 86 administering authorities (AAs) have come together in eight groups of their own choosing to move towards managing their investments through eight LGPS asset pools.

2.5. Most respondents to the Call for Evidence were positive about LGPS pooling, and thought that it was delivering scale, diversification of assets and cost savings. More than half of responses also recognised greater collaboration between funds in the same pool since the introduction of pooling.

2.6. However, it is clear that approaches and outcomes vary significantly across the LGPS. Some parts of the scheme have made very limited progress with transferring assets to the pool, where others are almost fully transferred. Some have delegated and compromised in order to enable benefits of scale at the pool level, whereas others have continued to require bespoke arrangements, preventing scale. Although each pool has reported successes to date, they are not equal in their ability to continue to develop to meet future challenges.

2.7. It is clear that a strong and consistent approach is needed to achieve the change required. Therefore, we are consulting on a series of measures which will require all LGPS funds to delegate the management of all their assets to their asset pool, alongside requiring that pools conform to a rigorous and universal set of standards. This model is informed by international best practice.

2.8. These measures would formalise standards for delegation, with the asset pools taking responsibility for all areas of investment implementation, whilst funds focus their attention on setting the overarching investment strategy, taking into account their membership and funding requirements. Pools would be required to develop the capability to provide their partner funds with investment advice to support their strategic decisions.

Local investment

2.9. The LGPS is a committed investor in projects which support local growth – around 5% of LGPS assets is estimated to be allocated to such projects as at March 2024.

2.10. The measures put forward would require administering authorities to work with local, mayoral and strategic authorities to identify local investment opportunities, and to have regard for local growth plans and priorities when setting their investment strategy. LGPS asset pools would be required to carry out due diligence on local investment proposals, to make the decision to invest in these opportunities where they deem it to be in the interest of the fund and its members, and to manage such local investments.

2.11. Pooling has played an important role in this story so far, and pooling has the potential to address many of the specific factors which make local investment harder for pensions committees. The reformed asset pools would be at the heart of the ability of the LGPS to continue to deliver investment in local economies.

Strengthening governance

2.12. LGPS membership and assets have tripled in the last decade – it is more important than ever that the scheme is effectively governed.

2.13. The reforms proposed in the consultation aim to ensure consistently high standards across the scheme and deliver the robust and resilient governance and administration which members and employers expect at both the pool and fund level.

2.14. Our proposals build on the report submitted by the LGPS Scheme Advisory Board in February 2021.[2] This includes the proposal of a biennial independent review to assess whether funds are meeting the expected standards on governance. Further measures are also proposed to ensure that the governance of funds and pools adapt to the proposed new remit of pools.

2.15. Taken together, these measures build on the successes which pooling has delivered to date, to put the scheme on a stronger more sustainable footing, working in partnerships with local institutions, in the interest of members, employers and local taxpayers.

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2 Good Governance Review Final Report.pdf

Workstream 3

Cost vs Value in the Defined Contribution Workplace Market

3.1. A key objective of the Pensions Investment Review is to promote a greater focus on the value provided by workplace DC pension funds rather than their cost.

3.2. There has been a consensus for some time that the DC market is not operating effectively. An excessive focus on keeping costs down has come at the expense of considering a broader range of metrics of scheme quality such as effective governance and net investment returns. This view was echoed throughout the responses we received to the Call for Evidence.

3.3. To an extent low costs are beneficial. It is right that pension providers face competitive pressure so that savers are protected from excessive or unfair charging practices, with workplace DC schemes used for automatic enrolment already subject to restrictions, including a cap on charges.

3.4. However, low investment budgets also make it harder for pension schemes to invest in more productive asset classes which may carry higher upfront investment costs but also offer higher net returns. This has consequences for scheme members and for investment in the economy.

3.5. Investment performance is critical for savers. Net returns account for 60% of the final pension pot[3] that individuals can hope to accrue over the course of their lifetime (alongside other important factors such as saving persistence and contribution levels).

3.6. However, there can be significant variation across pension providers – for example there is around an 8 percentage point difference in investment returns between the highest and lowest performing schemes.[4] Yet only around 5% of employers have switched their workplace pension schemes.[5]

3.7. To address these challenges the government has already announced plans to introduce a Value for Money (VFM) Framework and regulatory regime covering DC pension schemes in the upcoming Pension Schemes Bill. The VFM Framework looks to ensure that schemes deliver the

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3 Pension fund investment and the UK economy - GOV.UK

4 capaDATA

5 dwp-employer-survey-2022-data-tables.xlsx

best possible value and better long-term outcomes for savers. While respondents to the Call for Evidence were broadly supportive of the framework, some indicated concerns that it might not deliver the culture shift required unless all participants in the pensions ecosystem, particularly employers and advisers, were sufficiently incentivised to focus on value rather than cost.

3.8. The accompanying consultation document 'Unlocking the UK pensions market for growth' is seeking further evidence on measures that could seek to address this and support interventions like the VFM Framework. We will ensure that any changes we make are reflected in the design of the upcoming VFM Framework. We want to create space for innovation and ensure all measures build on and complement each other.

The role of employers

3.9. Employers are a key actor in the pensions market. Since 2012 they have played a crucial role in the success of AE, ensuring 9 out of 10 eligible people[6] are now saving into a workplace pension.

3.10. Many employers recognise the importance of their pension arrangements for their employees, sponsoring good quality provision and often acting as a force for good to drive up standards in the pensions industry more broadly.

3.11. The consensus amongst respondents to the Call for Evidence was that employers, particularly small employers, make scheme decisions based on costs rather than an informed long-term strategy and scheme performance, with operational simplicity also often a factor. Existing evidence[7] suggests that employers consider a range of factors when selecting a scheme - the top three factors for those selecting a DC scheme include ease or convenience of the provider (64%), advice from a professional body or formal advice from colleagues or other employers (51%) and the fees on the employer themselves (49%).

3.12. Some respondents to the Call for Evidence cited examples of decisions by employers around tendering coming down to a difference of charges of just a few basis points and many noted that there was significant room for manoeuvre for industry under the existing charge cap of 75 basis points to enable investment in more productive assets - average charges in DC workplace pensions sit at c.48 basis points.[8] Respondents also often indicated that the focus on cost in part related to the relative ease of comparing charges rather than other potentially less transparent metrics of value.

3.13. The upcoming VFM framework will help support employers (and their advisers) to make more informed decisions about pension provision by

6 Workplace pension participation and savings trends of eligible employees: 2009 to 2023 - GOV.UK

7 Evolving the regulatory approach to master trusts - GOV.UK

8 Pension charges survey 2020: charges in defined contribution pension schemes - GOV.UK

providing timely, consistent, detailed and publicly available information on the relative performance of similar default arrangements.

3.14. One proposal that was suggested by respondents to the Call for Evidence was to place a requirement such as a duty on employers to consider value, at scheme selection decisions or at regular intervals.

3.15. The Pension Schemes Act 2008 places duties upon employers to automatically enrol eligible employees into a qualifying pension scheme (which satisfy some minimum requirements). While limits have been set on the level (and some types) of charges that can be levied on members by schemes, there are no value requirements that must be met for employers to discharge their duties. Any additional duties would need to consider the impacts on business and whether the duties should be targeted, either by types of employer or at specific decision-making points. The government is seeking views on the efficacy and impact of such a measure.

The role of consultants and advisers

3.16. To support their decision making, some employers seek advice from third party advisers, typically when they are selecting a scheme or seeking to move from an existing scheme to a new one. There are also other important participants in the market including investment consultants, who provide advice to pension scheme trustees about investment strategy and related matters.

3.17. Respondents to the Call for Evidence indicated that professional advisers and consultants can play a significant role in influencing the decisions taken by multi-employer pension schemes and employers in relation to cost and investments.

3.18. Specifically, some stakeholders have raised concerns that professional advice, especially advice provided to employers, may be placing excessive weight on cost savings, aggravating the problem described above. The government wants to understand the prevalence of this, recognising that these advisers are ultimately driven by their clients' preferences.

3.19. At present, there is no specific regulatory regime regulating pension scheme selection advice or investment consultancy. There were some suggestions in the Call for Evidence to bring advisers into FCA regulation. Some respondents noted that this form of regulation would mean that advisers are required to consider the value of schemes or investment strategies in their advice, which could address the excessive focus on cost.

3.20. Therefore, the government wants to understand exactly to what end and how new regulation would play a role in ensuring that advice consistently considers returns alongside costs to ensure that the best interests of pensions savers are being served.

Workstream 4
UK Investment

4.1. Growth is the number one mission of this government. Had the UK grown at the OECD average over the past 14 years, our economy would now be £140 billion larger. That would have generated £58 billion more in tax revenues in the last year alone to sustain our public services.

4.2. If growth is the challenge, then investment is the solution.

4.3. As the DWP analytical publication 'Pension fund investment and the UK economy' shows, domestic pension fund investment can benefit UK growth in numerous ways.

4.4. The measures in this Interim Report will achieve this by priming pension schemes for additional investment in productive asset classes such as infrastructure and private equity, for example through increased scale.

4.5. The reforms will complement key government growth programmes aimed at creating an attractive pipeline of investment opportunities such as the National Wealth Fund and the British Growth Partnership. These programmes are the first step to drive greater alignment and coherence across the UK's public finance institutions, enabling a more strategic and impact focused approach to mobilising capital.

4.6. Their impact on growth will, however, depend on how much of this expected additional investment takes place in the UK and from where any additional investment is diverted.

4.7. As emphasised by some respondents to the Call for Evidence, while scale and interventions to prioritise value may be effective in unlocking additional investment in productive finance, it is not guaranteed that this investment will take place in the domestic market. Consolidation and scale will allow funds to manage assets more efficiently and at reduced risk. Greater in-house expertise and capacity will allow investment in a diverse set of asset classes, particularly in private markets assets.

4.8. The Review is encouraged by clear evidence that where pension schemes are managing private market portfolios, they tend to operate a significantly higher domestic weighting than in more liquid asset classes. This strengthens the case that these reforms driving scale and unlocking greater alternative investments will benefit UK growth. Furthermore, as outlined in Workstream 3, proposals for the LGPS will enhance the capacity and capability for the £392bn scheme to continue to drive national, local and regional investment and will help to ensure investments are able to reach all corners of the nation.

4.9. At this stage the Review has decided not to make specific recommendations in relation to UK investment, beyond those outlined in the LGPS chapter relating to local investments.

4.10. However, the government is concerned by the evidence that UK pension funds are investing significantly less in the domestic economy than overseas counterparts.

4.11. For example, DWP analysis has found that there is a 30-percentage point gap in the amount of home investment across asset classes in UK DC funds compared to Australia. And there is clear evidence of a sustained pattern of withdrawal by DC and LGPS pension schemes from UK listed equities for at least the last decade.

4.12. The Review will therefore use its next stage to consider whether further interventions may be needed by the government to ensure that these reforms, and the significant predicted growth in DC and LGPS fund assets over the coming years, are benefiting UK growth.

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This document can be downloaded from www.gov.uk

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