THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

By email only: PENSIONS.INVESTMENT@DWP.GOV.UK

10 May 2022

Dear DC Policy, Investment and Governance Team

SPP response to consultation: Facilitating investment in illiquid assets by defined contribution pension schemes

We welcome the opportunity to respond to this consultation and have here incorporated your reply form.

Executive Summary

We believe that the main barriers to DC investing in illiquids come from the need to offer DC members daily valuations, daily liquidity, to comply with permitted links and issues arising from performance related fees and fee look through. The success of measures to tackle these barriers will be crucial to the future of DC Investing in illiquids. Introducing the Disclose and Explain Policy proposals does not address the main barriers to DC schemes investing in illiquid assets. However, it may incrementally encourage some schemes to consider and ultimately increase their allocation, as and when these barriers are removed.

The proposals as outlined seem overly complex and likely to incur costs that do not justify the benefits. We have outlined what we believe to be appropriate disclosures that would achieve what we believe to be the intended policy aims.

Yours faithfully

Natalie Winterfrost
Chair, Investment Committee, SPP

Fred Emden
Chief Executive, SPP

Department for Work & Pensions

Consultation Questions: Facilitating Investment in Illiquid Assets

Name of respondent(s)/organisation (please provide):

The Society of Pension Professionals

Pension Scheme type (cross all those that apply)

Master Trust (500+ employers approx.): ...

Master Trust (fewer than 500): ....

Single-employer trust: ....

Contract-based:...

Defined Benefit:...

Hybrid:..

Administration: ....

Investment consultant: ....

Consumer organisation: ....

Law firm:...

Other (please state): **Trade Organisation**

Please indicate, next to any responses given, if you are **not** content for DWP to publish relevant sections of your responses in the future. Without a specific request for anonymity, we reserve the right to publish your response in full.

Chapter 2: Introducing Disclose and Explain Policy Proposals

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

These proposals are being made in the context of ever increasing reporting obligation which apply to pension schemes, in particular:

- additional requirements concerning their Statements of Investment Principles, introduced in 2018 and 2019 (to disclose policies in relation to financial material considerations, non-financial matters and stewardship, and to implement the Shareholder Rights Directive, respectively); and
- for certain schemes, new requirements to report in accordance with the Taskforce on Climate-Related Disclosure recommendations.

We therefore note that it is essential that any further reporting obligations are proportionate and we address this throughout our response.

We agree that the scope of this Disclose and Explain policy should be restricted to DC only and the DC section of hybrid schemes and not extended to DB schemes.

Specifically, we do see a role for illiquid investments in DC schemes. Liquid markets have delivered good returns historically, but a broader opportunity set is needed going forward.

Many DC scheme trustees dismiss the idea of illiquid investment as a consequence of the many known challenges, e.g.:

- performance related fee structures, which currently lead to a risk of breaching the charge cap and while this is under review, we still need 'well-designed' performance related fees to emerge;
- inequality in the disclosure of costs of some illiquid structures when compared to equivalent liquid structures (issues on look through were made by SPP in our response to DWP Consultation on Improving Outcomes for members of defined contribution pension schemes and have not been resolved);
- the fact that the Master Trust and GPP market competes predominantly on price and not investment sophistication and performance, making it less appealing to include illiquids at a meaningful enough level to justify the increased governance costs;
- the need to be equitable across members investing and divesting at different times with fair pricing but the lack of a market price for illiquid investments;
- the 'J-curve' and how this impacts on value for members selling in the early years of an illiquid investment;
- fund platforms remain reticent to add non-daily dealing funds onto platform given the increased governance and on-boarding challenges; and
- overall, the availability of illiquid funds on DC platforms, as a result of many of the above.

The Disclose and Explain policy does not directly solve any of these issues, but it could necessitate a periodic review of whether the reasons for not investing still hold true and as other policy solutions address the above, may encourage DC investment into illiquid assets as soon as suitable. As such we support a requirement for the SIP to disclose and explain their policies on illiquid investment.

While we support the proposal for the Chair's Statement to disclose the default asset allocation, including illiquids, it should not also include a policy explanation (the place for that is in the SIP) – please see our answer to question 4 for further detail.

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

While there will be a cost, we do not believe it would take a significant trustee resource to document reasons, such as those given in our answer to Q1, for not investing in illiquid assets and like we stated above should cause trustees to periodically challenge whether these beliefs still hold. We believe that the most suitable place to do this is in the Statement of Investment Principles (SIP). While this does not need to be reviewed more frequently than every 3 years, or after a significant change in policy, we do expect that if beliefs no longer hold true, the SIP would be reviewed and updated, which would prompt a rethink on whether trustees should continue to exclude illiquid assets.

Likewise we agree that the SIP for the default fund could document what illiquids are available and reasons for their selections and, with illiquids more likely to be suitable at this time for a default fund and with the bulk of DC monies going into default options, this would have the most impact.

We support the focus on default strategies only, given the vast majority of members invest in them and since this is consistent with the existing content required in SIPs. A policy relating to self-select funds could encourage wider adoption of illiquid assets should suitable funds be available and should trustees be comfortable that members are aware of the risks involved; however, this should by no means be a priority and a light touch approach would be essential, particularly where there is a large range of self-select funds on offer.

We do not think it would be appropriate for the SIP to document more specifically which members have allocations, beyond recognising the age dependency of asset allocations in lifestyle structures, as this is not an investment belief, and nor do we see it adding particular value.

We touch on it again in our answer to question 8, but we do not see a benefit in quarterly disclosures of DC default average allocations to illiquids or to quarterly disclosure of asset allocation more broadly. In our view calculating a mean allocation is unnecessary – the calculations will require significant data collection and computation, be a material cost and add little (or no) value. It is our view that a 'snapshot' disclosure at year end, along with access to a scheme's SIP and to the implementation statement which highlights changes to strategy, is adequate.

We are also concerned that perceived 'competition' between schemes in terms of a simple perception that higher illiquids is better encouraged by disclosures, could potentially be detrimental to the responsibility to run a scheme in the best interest of its own members.

We strongly believe that DWP should justify the benefit to members before requiring asset allocation disclosures.

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

At an asset level we believe that an illiquid asset is one that does not have a regularly observable market price, such as private equity, property, direct lending, commercial real estate loans, etc. However illiquid assets may be offered in liquid structures e.g. listed infrastructure, closed ended investment trusts or REITs. We would not include a REIT in the definition of illiquids, despite the underlying asset exposure, because they are equity securities traded on recognised exchanges. Whereas we would consider a non-listed pooled fund investment into illiquid assets e.g. a PUT, as an illiquid investment. Such vehicles are priced based on subjective valuations of the underlying assets and secondary market unit sales are 'off market'.

While it might be easier to define liquid investments (cash, listed equity and public fixed income) with illiquids being those assets that don't fall into these definitions, consisting of: private equity, private debt, infrastructure, property and other illiquids (e.g. agriculture), on balance we support Option 2 using a look-through approach based on how regularly assets can be traded.

As a minimum, we would suggest assets that are traded less regularly than weekly to be classified as illiquid assets. This recognises that managers may invest in sub-funds that are traded weekly despite providing exposure to liquid assets. However, a definition based on assets traded less than monthly could be considered to make the use of 'true' illiquid asset classes clearer.

The distinction between the liquidity of a fund vehicle and its underlying holdings is important. Using look-through, Option 2 would show the illiquid holdings within a daily dealt DGF, for example. However, we do not think it would be appropriate for a look-through approach to treat daily/weekly traded holdings in a monthly (or less regularly) dealt fund as liquid. This is because the assets could not be accessed at short notice and this is a complexity that needs to be considered.

In our view, the definition adopted for the purpose of the SIP should be consistent with any asset allocation disclosures introduced to the Chair's Statement. Some pooled fund investments e.g. Diversified Growth Funds, may be predominantly listed but have exposures to unlisted assets. We would favour a year end 'look through' of such multi asset structures, but note that there is work, and a reliance on fund manager disclosures, in compiling such a look through asset allocation.

Any DWP guidance providing for schemes to make assessments on a "look-through" basis would need to take into account how this concept applies in other contexts (e.g. in assessments of fees) to avoid inadvertent consequences (as mentioned in our earlier response to question 9 of the DWP's consultation on "Improving outcomes for members of defined contribution pension schemes").

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?

We are comfortable with disclosure of the trustee policy in relation to illiquids in the SIP.

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?

We would agree with broad asset class headings being used, but the exact headings should be determined once agreement has been reached on the definition of illiquids. We do not believe sub-asset classes disclosure should be a requirement and should be at trustee discretion – at this level, disclosure becomes subjective and potentially spurious and is likely more information than pension members need or will understand.

We view calculating a mean quarterly allocation as unnecessary – the calculations will require significant data collection and computation, be a material cost and add little (or no) value to members. It is our view that a 'snapshot' disclosure is adequate.

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

If the disclosures are simplified in the manner we suggest, we agree that a £100 million threshold is appropriate in order to achieve the objectives set out in the consultation in a proportionate way, however the threshold should be assessed only against the assets held in the DC sections of hybrid schemes. We note that this threshold coincides with the threshold for assessing member value. The disclosures as proposed would not be suitable for schemes of £100 million. We would see these as only suitable for schemes of £1 billion or more.

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

We support an alignment of approaches where possible and using ages 25, 45 and 55 seems reasonable. However we note that these ages are all within accumulation and DC Mastertrusts are providing decumulation solutions, some of which already have illiquid allocations. An in retirement age may be an appropriate addition where decumulation solutions are offered.

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

No. The Chair's Statement should cover topics of most interest to members, but it is already a complicated and confusing document in many cases. We would not support further complex disclosures in this document. However, we would support an asset class breakdown, showing allocation to illiquids at year end, being included in the Chair's Statement. In addition to the above, the implementation statement will already highlight any changes to illiquid asset allocations over the year. We would not support a requirement for any new document nor quarterly (and/or average) asset class disclosures.

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.

On an ongoing basis trustees will need input from their investment consultants to support them with these disclosures. While we have not surveyed our members on their expected costs, and it is hard to provide a sensible estimate while details are under consultation, for the disclosures we recommend in this response we would estimate first year investment consulting fees of £2.5k-£6k and annual ongoing costs in the region of £1k (which would be multitudes higher if average allocations and more frequent disclosures were required).

Additionally many trustees may feel they need to seek legal advice that their proposed approach is consistent with new requirements in the first year. This could be an additional £3-5k (again, we have not surveyed our members).

Trustees would find it reassuring if they knew no action would be taken in the first year if their disclosures did not meet expectations, with guidance being the consequence.

Chapter 3: Employer-related investments – Consultation on draft regulations

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?

Yes.
In our experience the breadth of the current ERI regulations, in particular the fact that they apply to all scheme employers and any person connected or associated with any employer means that in practice it can be difficult for a master trust trustee to conclude with sufficient certainty that a potential private debt/credit investment would not involve the risk of an inadvertent breach of the employer-related loan restrictions (see further our response to Question 11). Given that the employer-related loan restrictions are a "hair trigger" and any breach (even a minor and unintended one) is a criminal offence, this can dissuade master trusts from making investments in this area.

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

We broadly welcome the draft regulations as being a helpful change to the current ERI regime. We would make three observations in relation to the detail of the draft regulations:

a) The draft regulations limit the scope of the ERI restrictions to the scheme strategist and scheme funder and any entity "connected or associated" with them. Removing the ERI restrictions from individual employers is a helpful change and makes very good sense. However SPP members were divided on whether applying the requirement to the scheme strategist and scheme funder was necessary in the context of a DC Master trust. Reliance on the scheme funder should for most schemes of this sort of size be token at best, and focused on the costs of continuity options, whereas this restriction focuses on the investments made on the individual accounts. However a 20% cap should not cause a difficulty if the restrictions are applied.

b) We accept that the ‘’connected or associated” test is already used for “conventional” ERI restrictions, but we question whether it should be perpetuated for the master-trust-specific restrictions. The "connected or associated" test can be difficult to apply with sufficient certainty in practice – by way of context, a 350 page practitioners' text has recently been published solely on the subject of the connected or associated test and how to apply it. The test can produce unexpected and counterintuitive results, for example making two otherwise unrelated companies "connected or associated" where an employee, including any executive director (i.e. both an employee and director), of one company happens to be employed by another company (where regulation 10 of the 2005 Investment Regulations would not apply). The uncertainty around the entities caught by the test is unhelpful in a context such as the employer-related loan regime where (as noted above) there is in effect a "hair trigger" (i.e. any inadvertent breach constitutes a criminal offence) and this may lead to trustees of master trusts remaining reluctant to invest in private credit for this reason. In light of this, we would suggest that a different test which is more straightforward to apply in practice might better achieve the policy intent and "unlock" investment in this area – for example, one alternative approach might be to use the definitions of "holding company" and "subsidiary" in the Companies Act 2006 rather than the "connected or associated" test.

c) In relation to the proposed changes to The Application of Pension Legislation to the National Employment Savings Trust Corporation Regulations 2010 made by the draft regulations, we note that the amendment to remove paragraph (b) of regulation 4 altogether would seem to have a broader effect than proposed in the consultation. We can see the policy rationale for removing part of paragraph (b), specifically the Nest-specific easement that employer-related investments must not exceed 20% of the market value of the scheme (on the basis that an equivalent easement would in future apply to Nest as an authorised master trust), however paragraph (b) also includes a provision to the effect that government bonds are not to be regarded as employer-related investments in respect of Nest – the policy rationale for removing this is not clear. We would therefore suggest that paragraph (b) of regulation 4 should be amended rather than removed such that regulation 16(6) (as added to the Investment Regulations 2006 by paragraph (b)) is removed but that regulations 16(7) and 16(8) are retained.

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

We have no comment on this

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