XPS Investment

Briefing

February 2019

Investment opportunities for DC schemes set to expand

In brief

- The DWP is consulting on facilitating investment by occupational DC schemes in illiquid assets, such as smaller and medium-sized firms, social housing, green energy projects and other infrastructure
- There would be new annual reporting requirements (via the Statement of Investment Principles) for larger DC schemes investing in illiquid assets
- Smaller DC schemes would be required to conduct a triennial assessment of whether it is in members' interests to transfer to a 'larger scheme with scale'. Reporting of the assessment findings could be included in the Chair's Statement
- The DWP is proposing allowing an additional method for assessing compliance with the 0.75% charge cap so that performance-related fees can be taken into account
- The consultation period closes on 1 April 2019

XPS view

- The investment benefits of adopting the proposals are, in our opinion, only really likely to be achieved by addressing some additional challenges including those around daily pricing and governance

On 5 February 2019, the Department for Work and Pensions (DWP) launched a wide-ranging consultation which set out three main proposals designed to expand the investment options for occupational defined contribution (DC) pension schemes to include more exposure to illiquid assets.

The case for investing in less liquid/illiquid assets

Defined benefit (DB) pension schemes have often sought to benefit from their long-term investment horizons by seeking to invest in illiquid assets that are expected to deliver an 'illiquidity premium'. Such assets typically include small and medium-sized unlisted firms, social housing, green energy projects and other infrastructure – often collectively referred to as 'patient capital'. Whilst the amount of UK assets invested in occupational DC schemes is currently much lower than in their more-established DB counterparts, the closure of DB schemes and introduction of auto-enrolment have driven a rapid and accelerating growth in DC investment. According to data from the Pensions Regulator, occupational DC scheme assets have more than doubled in the four years to 2018 and growth is likely to accelerate with auto-enrolment contributions increasing from April 2019. Furthermore, around 95% of DC members are invested in their scheme's default funds and tend to remain invested there for many years.

Despite the growing significance of the DC market, the consultation identifies certain barriers that arguably restrict DC investment into long-term illiquid assets and makes a number of proposals designed to remove them.

Smaller scheme consolidation

One of the proposals involves the requirement for small DC schemes to conduct an assessment as to whether it might be in their members' interests to transfer to a 'larger scheme with more scale', such as a master trust. The argument behind this proposal is that additional scale would help to remove a barrier to investing in less liquid assets and would improve overall DC scheme governance.

The DWP suggests that trustees' assessments should be conducted at least every three years or following a significant change in scheme membership and that the results are published as part of their Chair's Statement (which must already include a 'value for members' assessment).

There is a strong investment case for increasing the diversification of the range of assets in which DC members can invest and providing an opportunity to benefit from the illiquidity premiums associated with long-term investing.

Charge cap barrier

A second proposal attempts to address the way in which the current charge cap applying to default funds may also be a barrier to investing in illiquid assets. Since April 2015, there has been a charge cap on the default funds of DC schemes used for automatic enrolment to protect members from excessive charges. The cap is set at 0.75% per annum of the funds under management, or an equivalent combination charge.

Funds that invest in illiquid assets typically levy a performance-related fee, which can make it difficult for trustees to determine whether a default arrangement complies with the 0.75% charge cap.

The DWP therefore proposes to allow the use of an additional method for assessing compliance with the cap so that performance-related fees can be taken into account.

The DWP has also taken the opportunity to provide an updated (non-exhaustive) list of costs and charges included in/excluded from the default fund charge cap.

Reporting on investing in illiquid assets

Finally, the DWP is proposing that 'larger' DC schemes – this could be defined as those with assets above £250m or £1bn, or with more than 5,000 or 20,000 members – be required to:

- document and publish in the main Statement of Investment Principles (SIP) (and potentially in their default fund SIP) their policy regarding the use of illiquid assets; and
- report annually on how they have followed this policy.

Reporting would be via the new Implementation Statement (which trustees of all schemes that are required to produce a SIP will already have to prepare from 1 October 2020), and would need to include an approximate percentage allocation to illiquid assets.

'Smaller' DC schemes (those below the proposed thresholds) and schemes whose only DC benefits derive from additional voluntary contributions would be excluded from the reporting requirements.

XPS Investment view

We welcome this consultation and the thinking behind the proposals. There is a strong investment case for increasing the diversification of the range of assets in which DC members can invest and providing an opportunity to benefit from the illiquidity premiums associated with long-term investing. These considerations are likely to become increasingly important as investor time horizons are expected to have to grow in the future. It is also likely that the proposals would give rise to an increase in capital being deployed into areas where it can be used to benefit society.

However, given that many DC scheme members already struggle to fully understand their existing investment choices and choose to continue with the 'safety' of the available default strategies, the proposals are likely to have a meaningful impact only to the extent that they impact on the design of those default strategies; where changes are made to the composition of other fund choices, the overall impact on DC investment into illiquid assets is likely to be negligible, we would argue.

We would also suggest that the effectiveness of the proposals rests on DC schemes changing their stance on offering daily dealing to members. Whilst this is not a regulatory requirement, most DC schemes have tended to offer daily dealing which precludes offering illiquid assets that are traded less frequently in the market. For most members, less frequent dealing is unlikely to lead to any real hindrance to their investment experience and should, therefore, be more prevalent.

The proposals would also represent a further governance and administration burden for trustees of any small DC schemes that chose not to consolidate, at a time where that burden is already increasing. This may mean that a number of small schemes are less likely to embrace the changes that the consultation is designed to promote.

Conclusion

The proposals are likely to go some way to removing certain barriers that have restricted the opportunities available to DC scheme members to invest in a more diverse range of illiquid assets. A significant increase in investment into these types of assets is only really likely to be achieved, however, by addressing some additional challenges including those around daily pricing and governance.

For futher information please get in touch with Guy Plater.

t 020 3327 5323

e guy.plater@xpsgroup.co.uk

@xpsgroup.com

company/xpsgroup