A Roadmap for Increasing Productive Finance Investment

Authored by the Productive Finance Working Group
September 2021
Members of the Working Group

abrdn (previously Aberdeen Standard Investments)
Association of British Insurers
Association of Investment Companies
Alternative Investment Management Association
Aviva
BlackRock
BNY Mellon
British Private Equity & Venture Capital Association
Fidelity International
Hargreaves Lansdown
HSBC
Impax Asset Management
Legal & General Group
London Stock Exchange Group
Macquarie Group
NEST Corporation
Partners Group
Pensions and Lifetime Savings Association
Rothsay
Simmons & Simmons LLP
TheCityUK
The Investment Association
Universities Superannuation Scheme
Willis Towers Watson
Two independent trustees of pension schemes
(Ruston Smith, Paul Trickett)

Steering Committee Co-Chairs

Andrew Bailey, Governor of the Bank of England
John Glen MP, Economic Secretary to the Treasury
Nikhil Rathi, CEO of the Financial Conduct Authority

This report would not have been possible without the generous contributions of the staff of the above organisations who lent their expertise and their organisations who made them available to produce this report.

Disclaimer: This report has been produced by the members of the Productive Finance Working Group, under the Terms of Reference, and reflects the members’ collective work and views. The report does not necessarily reflect the views of any individual organisation and does not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority), FCA or HM Treasury.

The Bank of England and Financial Conduct Authority have provided the Secretariat support.

If you have any questions, please contact the Secretariat at FSSR-Productive-Finance-Secretariat@bankofengland.co.uk and ProductiveFinanceWG@fca.org.uk.
Forewords

Strong investment in assets that provide returns over the longer-term is critical to the success of the UK economy: whether it’s providing capital to fund the post-Covid recovery, modernising infrastructure or supporting the transition to a carbon neutral economy.

Since the 2017 Patient Capital Review, the government has taken significant steps to address the barriers to investment in long-term assets. However, there is still more that can be done to improve the routes through which capital can be allocated into these sorts of investments, for the benefit of investors as well as our economy. The government’s determination to make further progress on this agenda was reflected in the ambition set out by Chancellor late last year to see the first Long-Term Asset Fund (LTAF) launch in 2021.

However, the success of the LTAF, and investment in long-term assets more generally, is not just dependent on putting the right regulatory structure in place. It relies on a coordinated and holistic approach by government, regulators, investors and investment managers. The Productive Finance Working Group has been an invaluable forum to develop such an approach, which is set out in detail in this report and its recommendations. If implemented, these recommendations have the potential to deliver significant and beneficial changes for both individual savers and the wider economy.

John Glen, Economic Secretary to the Treasury

The supply of finance for productive investment is important for long-term growth and productivity. It also helps to promote financial stability by increasing growth in a sustainable way. The economic uncertainty created by Covid means that it is now more crucial than ever that a long-term investment culture is fostered that delivers good outcomes for consumers while aiding economic recovery. Investment in less liquid assets can also have broader benefits, including facilitating the financing of long-term projects, such as the transition to a net zero carbon economy.

I, therefore, very much welcome and support the recommendations in this report to overcome barriers to investment in less liquid assets. It is vital that these recommendations are implemented in a timely manner, so that the benefits of greater investment in such assets are fully realised.

Andrew Bailey, Governor of the Bank of England

The investment landscape is changing. Individuals are increasingly responsible for their future financial wellbeing, and better outcomes and greater choice may be achieved if a more diversified set of investments is available. Against this backdrop, products offering exposure to alternative assets, such as productive finance, can play an important part in an individual’s investments, particularly their pensions.

Creating an environment where these types of investment can appropriately take place continues to be a priority for the Financial Conduct Authority. An example of this is our recent consultation proposing the introduction of a new authorised fund vehicle called the Long-Term Asset Fund (LTAF), which will help to facilitate greater investment in these types of assets.

I hope that the findings of the Productive Finance Working Group will translate into improvements in the financial wellbeing of individuals, as well as helping to support the broader economy.

Nikhil Rathi, CEO, Financial Conduct Authority
Executive Summary

1. Low interest rates and relatively slow economic growth by historic standards have increased the challenge for savers in terms of returns on their investments. One way of potentially achieving higher returns, net of cost, is by investing in longer-term, less liquid assets, managed appropriately and as part of a diversified portfolio. For example, evidence suggests that investment in such assets could be associated with a 1%-7% increase in returns over the long term.1 Investment in less liquid assets could also help reduce risk through greater portfolio diversification.

2. The current economic environment could create new commercial opportunities for investors seeking to boost their returns by investing in these types of assets. Many companies will need to restructure to adapt to post-Covid realities and respond to the mounting pressures to transition to a net zero economy. This would require taking longer-term investment horizons and create new types of higher-yielding, less liquid assets. This could also benefit the wider economy by aiding economic recovery and supporting financial stability by increasing sustainable growth.

3. One key group of investors that could benefit from investment in longer-term, less liquid assets is people saving for retirement, given their typically long-term investment horizons. UK workplace Defined Contribution (DC) pension schemes are an increasingly important vehicle for saving for retirement. Their assets have increased from around £200bn in 2012 to over £500bn today, and are expected to double to £1tn by 2030.

4. However, there is evidence that UK DC schemes invest relatively little in less liquid assets, compared with both their UK Defined Benefit (DB) and DC counterparts in some other countries, such as Australia. More than four-fifths of UK DC pension fund investments are in listed equities, and corporate and government bonds, which represent less than one-third of UK and other advanced economy assets. Two-thirds of DC schemes do not invest in longer-term, less liquid assets at all, and the rest invest only 15%-70% of their assets, much of which is in real estate.

5. The industry-led Productive Finance Working Group was specifically established to develop practical solutions to the barriers to investing in less liquid assets, focusing mainly on barriers faced by DC pension schemes. This report summarises these solutions – falling under the four main categories below – that will create an environment in which DC schemes and other investors can benefit from the appropriate long-term opportunities.

6. Crucially, implementing the recommendations identified in this report requires action by a broad range of industry and official sector stakeholders.

Shifting the focus to long-term value for DC pension scheme members

7. As the DC pension industry has grown, it has sought to ensure that costs to investors are kept low, supported by the implementation of the Department for Work and Pensions (DWP) charge cap, among other things. This was necessary against a backdrop of legacy products that had relatively high costs without necessarily generating sufficient value for members. However, as DC provision expands, an excessive focus on cost alone could result in investments, potentially providing better value for money, being overlooked – to the detriment of savers.

8. To shift the focus from cost to long-term value and improve member outcomes as the industry grows, we recommend DC scheme decision-makers (including trustees) and consultants actively consider how increasing investment in less liquid assets could generate better value for their members. This should be supported by proactive communication from DWP and the Pensions Regulator (TPR) on investment in less liquid assets, as in this report. Asset managers and DC schemes should work together to consider appropriate methodologies to accommodate performance fees within the charge cap. And as schemes continue to consolidate, DWP should consider in the future how to reconcile performance fees with the purpose of the charge cap and trustees’ ability to invest in a broad range of assets, including less liquid ones.

Building scale in the DC market

9. The UK DC market is characterised by a long tail of small schemes, which make longer-term investment less accessible for the majority of the market. These schemes are a key reason why a continued focus on cost has been necessary and could explain why investment by DC schemes in longer-term assets is lower, compared to DB schemes and some other jurisdictions.

10. To address the barriers from this lack of scale, DWP should continue with a DC schemes consolidation agenda, where it is clear that schemes are not providing value for members. DC schemes, themselves, should consider whether their scale is a barrier to good member outcomes including to the potential benefits of greater investment in less liquid assets.

A new approach to liquidity management

11. Increased investment in less liquid assets increases the importance of robust liquidity management, given that many of these assets cannot be bought and sold daily. We believe that a broader range of DC schemes can find approaches that enable them to invest in less liquid assets as part of a diversified portfolio, while also meeting liquidity needs of DC scheme members.

12. Alongside support for trustees managing liquidity at the DC scheme level, they would also need a range of products that provide access to less liquid investments. In addition to existing opportunities, we have also developed the key elements of the Long-Term Asset Fund (LTAF) – a proposed new authorised open-ended fund structure that the Chancellor has committed to launch and the Financial Conduct Authority (FCA) has consulted on. The LTAF is specifically designed for investment in less liquid assets, and requires aligning the redemption policy of the fund with the liquidity of its assets.

13. To support appropriate liquidity management and give trustees greater confidence in investing in less liquid assets, we recommend that industry participants and trade bodies develop guidance on good practice in liquidity management at a fund level, focusing on appropriate ranges for dealing frequency and notice periods for the different asset types for the LTAF.

Widening access to less liquid assets

14. There are a range of ways to invest in less liquid assets, and all of them play important roles in meeting the needs of different investor groups.

15. To support the distribution of less liquid assets, including via the LTAF, to a broader range of investors, including DC schemes and retail, when appropriate, we recommend that the FCA consults on changing its rules for investment in illiquid assets through unit-linked funds and reviews its rules for distribution to appropriate retail clients, respectively.

Next Steps

16. Industry members of the Working Group and the official sector have committed to moving forward the proposed recommendations set out in this report. Without such actions by all stakeholders, greater investment in less liquid assets and the opportunity of securing greater potential long-term value for pension scheme members in their retirement will be harder to achieve. Crucially, this will also require broader action across the industry, not just the Working Group members. We will meet in early 2022 to monitor the progress in implementing these solutions and consider any further action.
Recommendations

This section summarises the recommendations of the Productive Finance Working Group, which require action by industry and the official sector in order to make progress on removing the barriers to investment in less liquid assets. There are four key recommendations, accompanied by specific actions to achieve these.

RECOMMENDATION 1: Shifting the focus to long-term value for DC pension scheme members

DC pension schemes are primarily focused on cost, which the larger schemes currently compete for business on. This reduces the attractiveness of investment in less liquid assets (which often bear greater costs), even if they present the opportunity to create greater value for their members. As such, there is a need to shift the focus from cost to long-term value and enhanced outcomes for DC scheme members. To achieve this, we recommend the following:

a. DC scheme trustees are the ultimate decision maker on investment for most of their members and need to focus on long-term value for them.² Where appropriate and in their members’ interests, trustees should actively consider how increasing investment in less liquid assets (including through newly created LTAFs) could generate greater value for their members, and monitor long-term returns using robust metrics.

b. Consultants play a key role in supporting DC schemes in making investment decisions. Consultants should therefore:
   (i) endorse the objectives of this work; and
   (ii) integrate allocations to less liquid assets in their recommendations to their DC scheme clients, when appropriate.

c. Recognising the challenges associated with investing in less liquid assets, trade bodies should further raise awareness of the benefits and operational considerations of investment in less liquid assets, including on how to manage the risks.

d. To support DC schemes’ investment in less liquid assets – particularly, mid-range schemes which do not have significant bargaining power – the legal profession, asset managers, DC schemes and investment consultants to work together in the appropriate forum to consider:
   (i) appropriate methodologies to accommodate performance fees within the charge cap; and
   (ii) appropriate terms and conditions, more generally.

Industry should engage with the official sector on the results of their work.

e. The charge cap plays an important role in protecting pension scheme members, but can also risk contributing to a focus on cost over value. As DC schemes consolidate and the industry builds scale, DWP should:
   (i) continue to monitor the overall impact of the charge cap;
   (ii) continue to consider how to reconcile performance remuneration (that may be associated with greater overall value for members) and the charge cap rules and;
   (iii) confirm that transitional arrangements would be considered if the charge cap were to change.

f. To shift the focus from cost to value and make an impact that is only possible through collective action, DWP and TPR should consider ways to proactively communicate their supportive messaging on investment in less liquid assets, as they have in this report (e.g., publishing additional guidance for trustees on investing in less liquid assets).

² Throughout the report we use the term ‘trustees’ to refer to a broader range of DC scheme decision-makers, also including insurance companies’ in-house investment teams and Independent Governance Committees.

RECOMMENDATION 2: Building scale in the DC market

Investment in less liquid assets often requires expertise and knowledge that would typically only be available to larger DC pension schemes. It is therefore important to encourage greater levels of DC pension scheme consolidation in the market to support a shift of focus to value, and to provide greater opportunity to invest in less liquid assets. To help achieve this, we recommend the following:

a. A lack of scale is a key barrier for DC schemes in investing in less liquid assets. Increasing scale is likely to facilitate greater investment in such assets, for example, by raising schemes’ bargaining power in relation to their fees and their ability to draw on the relevant expertise in making such investments. To address the barriers from the lack of scale in the long tail of smaller DC schemes, DWP should continue with a DC schemes consolidation agenda, where it is clear that schemes are not providing value for members.

b. DC scheme trustees to assess their scheme’s ability to deliver value and access a diversified range of asset classes at its current scale in their consideration of whether to consolidate.

c. The FCA should support this by providing information to trustees about how asset managers are required to price units, in particular in an LTAF context.

RECOMMENDATION 3: A new approach to liquidity management

DC schemes have liquidity needs that are driven by their members’ needs. Most DC schemes currently invest predominantly in daily-dealing funds. This means that, in theory, all their holdings can be sold at short notice to realise cash, thereby allowing them to meet members’ needs. Investments in less liquid assets usually do not present the same redemption opportunities, and, as such, careful consideration will need to be given to appropriate liquidity management at the DC scheme and underlying fund level. We recommend the following:

a. To support appropriate liquidity management at DC scheme level and give trustees greater confidence in investing in less liquid assets without putting at risk their obligations to their members, DC schemes will need support and guidance at a fund level. Industry participants and trade bodies should develop guidance on good practice on a toolkit for liquidity management at a fund level, in consultation with the FCA and Bank of England in the context of their broader work on liquidity classification for open-ended funds. This guidance should focus on appropriate ranges for dealing frequency and notice periods for different asset types.

b. Drawing on this guidance, asset managers should develop products, including LTAFs, that suit DC schemes’ needs and give trustees greater confidence in investing in less liquid assets.

c. The FCA should support this by providing information to trustees about how asset managers are required to price units, in particular in an LTAF context.
**RECOMMENDATION 4: Widening access to less liquid assets**

There are currently various ways in which investors can access less liquid assets, including through closed-ended funds and investment trusts. That said, there is an opportunity to increase the range of available products, including open-ended, FCA-authorised vehicles, which might appeal to those investors that do not currently invest in less liquid assets. We recommend a series of actions to support the distribution of less liquid assets, including through the LTAF, to a broader range of investors including DC schemes and retail investors, where appropriate.

1. The FCA to consult on removing the 35% cap on investment in illiquid assets for all permitted links, where the underlying investor is not self-selecting their investments.

2. The FCA to review the application of the Financial Promotion rules to the LTAF, including the classification of the LTAF as a non-mainstream pooled investment (NMPI), once LTAFs are established. In addition, the FCA to consider further the appropriateness of applying this framework to the LTAF as part of its review of the potential safe distribution to retail investors more broadly. Where the FCA considers that changes to its rules might be appropriate, it should follow its usual public consultation process.

While the recommendations for market participants are directed at the industry at large, below is the list of the Working Group members who have volunteered to drive forward various elements of their implementation, drawing in other organisations as appropriate:

- Abrdn, Association of British Insurers (ABI), Association of Investment Companies (AIC), Alternative Investment Management Association (AIMA), Aiviva, BlackRock, BNY Mellon, British Private Equity and Venture Capital Association (BVCA), The City UK (TCUK), Fidelity, Hargreaves Lansdown, Investment Association (IA), Legal & General, Macquarie Group, NEST, Partners Group, Pensions and Lifetime Savings Association (PLSA), Simmons & Simmons LLP, Universities Superannuation Scheme (USS), Willis Towers Watson, and a professional trustee (Ruston Smith)

Diagram 1 puts the implementation of these recommendations in a broader context of a series of actions that aim to facilitate greater investment in less liquid, long-term assets.
Diagram 1.1: A Roadmap for Increasing Productive Finance Investment

- **Work begins on investigating the barriers and potential solutions** January 2021
- **Working Group is announced and convened** November 2020
- **Working Group’s report published, implementation of the recommendations begins** September 2021
- **Substantive progress to be made on implementing the recommendations ahead of Working Group Steering Committee meeting** Q1 2022
- **Recommendations fully implemented, paving the way for increased productive finance investment** Q2 2022

2020

- **DWP launches Consultation on the charge cap** March 2021
- **FCA consults on the LTAF** May – June 2021
- **DWP issues response to charge cap and consolidation consultations, plus new call for evidence on further consolidation** June 2021

2021

- **Working Group Steering Committee approves findings and recommendations** July 2021
- **FCA and TPR launch joint discussion paper on value for money in DC pension schemes** September 2021
- **FCA and TPR launch joint discussion paper on value for money in DC pension schemes** September 2021
- **New DWP regulations on performance fees, net returns and consolidation come into force** October 2021
- **DWP issues response to charge cap and consolidation consultations, plus new call for evidence on further consolidation** June 2021
- **DWP launches Consultation on the charge cap** March 2021

2022
1. Introduction

1. The industry-led Productive Finance Working Group was convened by Her Majesty’s Treasury (HMT), the Bank of England and the FCA in November 2020, to develop practical solutions to the barriers to investment in long-term, less liquid assets, with a focus in particular on barriers faced by DC pension schemes. Addressing these barriers will support DC schemes to achieve long-term value for their members and allow greater investment in productive finance, including venture capital, private equity and infrastructure.  

2. There are several vehicles that can facilitate investment in long-term, less liquid assets, including investment trusts, qualified investor schemes (QIS), European Long-Term Investment Funds (ELTIF) and others. A high priority and early deliverable for the Group was to facilitate the successful rollout of the Long-Term Asset Fund (LTAF) structure and to consider what is required to ensure it is operationally, commercially and legally viable for a range of investors. The LTAF is a proposed new authorised open-ended fund structure that the Chancellor has committed to launch and the FCA has consulted on. It could supplement other existing structures and broaden the range of investment opportunities for DC schemes and other investors. While we agreed that the focus should be addressing the barriers for DC schemes, given it is a growing market with clear barriers to investment in less liquid assets, consideration was also given to distribution to a broader range of investors, including retail.

3. Importantly, we recognise that the LTAF is one of the many vehicles for investment in less liquid assets and have considered this structure in a broader context – to ensure that proposed solutions could also unlock investment in less liquid productive assets, more widely.

4. The Working Group membership has comprised a broad range of industry participants, including pension schemes, investment consultants, asset managers, pension scheme trustees, investment platforms, a law firm, and trade associations. A full list of members can be found here, and the minutes of the meetings here.

5. The views expressed in this report are based on extensive discussions both among the Working Group members and with the broader industry and official sectors. Group members spoke with a large number of a broad range of stakeholders involved in each step in the investment decision chain for DC pension schemes. We have also sought to build on previous initiatives in this area, including HM Treasury’s Patient Capital Review, Oliver Wyman and the British Business Bank’s report on The Future of Defined Contribution Pensions, and the UK Funds Regime Working Group’s final report to HM Treasury’s Asset Management Taskforce.

6. This report sets out our findings and recommendations:

• Section 2 outlines the case for investment in less liquid assets and evidence of low levels of such investment by UK DC schemes;

• Sections 3-6 consider the key barriers to DC schemes’ investment in such assets, and sets out proposed solutions. We have grouped them into four categories: shifting the focus from cost to value for DC pension scheme members; building scale in the DC market; adopting a new approach to liquidity management; and widening access to less liquid investment, including to retail investors.

---

4 The Chancellor outlined his ambition to see the first LTAF launched in 2021 in his Future of Financial Services Speech in November 2020, see: https://www.gov.uk/government/speeches/chancellor-statement-to-the-house-financial-services. 
2. The case for investment in less liquid assets and the current DC pension scheme landscape

1. Investment in long-term, less liquid assets, managed appropriately, can help savers secure higher net returns. It also provides various challenges, including that it may require long-term commitments from investors. This section sets out why investing in less liquid assets could be in the interests of members of DC schemes, and considers evidence on UK DC schemes’ investment in such assets and the barriers to that.

2.1. THERE IS A STRONG CASE FOR INVESTMENT IN LESS LIQUID ASSETS AS PART OF A DIVERSIFIED PORTFOLIO...

2. Pension scheme members receive regular illustrations setting out their projected investment returns under the assumption of high, medium and low returns. The gaps between these are typically material and can make the difference between a comfortable retirement for members and one that is less so. Investment in less liquid assets, such as infrastructure, private equity (PE) and venture capital (VC), as part of a diversified portfolio – and with the appropriate advice and due diligence – could support pension schemes’ ability to improve retirement outcomes for their members.

3. While no investment return can be guaranteed and past performance may not be a good guide for the future, a wide range of literature illustrates how less liquid assets can outperform their more liquid, often listed, counterparts. For example, empirical estimates by Oliver Wyman and the British Business Bank suggest that a 22-year-old new entrant to a default DC scheme with a 5% allocation to VC/GE could achieve a 7%-12% increase in returns over the long term.

4. Empirical evidence also suggests that private markets, such as PE and VC, could meaningfully outperform public markets. For example, as at 2019, the previous five-year and ten-year annual returns of funds managed by British Private Equity and Venture Capital Association (BVCA) members were 20.1% and 14.2%, respectively, compared to 7.5% and 8.1% for the FTSE All-Share, respectively, over the same time periods. The US PE industry has also outperformed US public markets by an average of 6% per year over the last 20 years (Chart 2.1). And between 1970 and 2016, global VC/GE assets have outperformed global public markets by 7 percentage points per year (Chart 2.2). There is also some evidence on the potential increased returns from investments in private debt and infrastructure.

5. These potential additional returns could make a material difference to the size of DC scheme members’ pension pots at retirement.

---


https://www.avivainvestors.com/en-gb/views/real-assets-house-view


https://www.avivainvestors.com/en-gb/capabilities/real-assets/case-for-private-debt/


https://www.en.wikipedia.org/wiki/Private_equity

---


CHART 2.1: GROWTH OF A HYPOTHETICAL $100,000 INVESTMENT (1999-2018)

CHART 2.2: GLOBAL VC/GE HAS OUTPERFORMED TRADEABLE EQUITIES IN EACH DECade SINCE 1970
Allocating to less liquid assets also offers the benefits of diversification, which can help manage portfolio risk, reduce volatility and enhance returns. For example, adding less liquid assets to a hypothetical portfolio comprised of 60% stocks and 40% bonds would have increased returns and reduced volatility materially between 2004 and 2018 (Table 2.1). These benefits, in part, reflect less liquid assets tend to have a low correlation with other assets.  

### Table 2.1: Impact of Adding Less Liquid and Illiquid Assets to a 60/40 Portfolio (9/30/2004-12/31/2018)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Return</th>
<th>Volatility</th>
<th>Sharpe Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks/bonds</td>
<td>6.7%</td>
<td>8.58%</td>
<td>0.62</td>
</tr>
<tr>
<td>Private equity (PE)</td>
<td>55/35/10</td>
<td>7.5%</td>
<td>8.55%</td>
</tr>
<tr>
<td>Private debt</td>
<td>50/30/20</td>
<td>8.2%</td>
<td>8.56%</td>
</tr>
<tr>
<td>Private real estate</td>
<td>55/35/10</td>
<td>7.1%</td>
<td>8.09%</td>
</tr>
<tr>
<td>Blended portfolio (PE/loans/real estate)</td>
<td>50/30/20</td>
<td>7.4%</td>
<td>7.62%</td>
</tr>
</tbody>
</table>

The hypothetical 60/40 portfolio is represented by the S&P 500 Index and Bloomberg Barclays U.S. Aggregate Bond Index. Private equity is represented by the Cambridge Associates U.S. Private Equity Index. Private real estate is represented by a 50/50 allocation to the NFI-ODCE Index and the Gilberto-Levy Commercial Mortgage Index. Private debt is represented by the Cliffwater Direct Lending Index.

Sharpe ratio is an asset’s excess return (the amount over the risk-free rate) divided by the standard deviation of excess returns. A higher value generally signifies a more attractive risk-adjusted return. Past performance is not indicative of future results. This data is for illustrative purposes only and is not indicative of any investment. An investment cannot be made directly in an index. Source: ‘Liquidity Paradox’, FS Investment Solutions (2019).

7. Investment in less liquid assets can also have broader benefits, including facilitating the financing of long-term projects, such as the transition to a net-zero carbon economy. Many less liquid investment strategies involve direct relationships with the underlying business or project, which can offer investors greater influence over environmental, social and governance (ESG) or sustainability issues. Adding less liquid assets to a diversified portfolio, which are likely to play an important role in the growth of the economy more generally.

8. Although there are benefits to investing in less liquid assets, they also present different risks to more liquid ones and may not be suitable for some investors. For example, by their nature, such assets typically involve liquidity risk, whereby investors may have to wait significant lengths of time to realise their investments. A large infrastructure project, such as a windfarm, for example, is likely to require investors to tie up cash for many years. Conversely, the shares of many companies listed on an exchange can usually be traded frequently throughout the day.

9. Several factors could help reduce liquidity risk. An appropriate fund structure design could help align the liquidity of the fund with that of its assets (Section 5). Such risks are also likely to be less material where allocations to less liquid assets are made as part of a diversified portfolio, such as within a DC scheme default arrangement, where liquidity may be sourced from other parts of the portfolio. Finally, as retirement investment vehicles, DC pension schemes have long investment horizons. Scheme members are unable to access their pensions until age 55, so those joining a pension scheme after leaving school or university have an investment horizon of at least 30 years. Some scheme members may also choose not to access their pension until they are significantly older, further increasing the investment horizon.

10. UK workplace DC pension schemes are increasingly the key vehicle through which UK employees save for retirement. The introduction of automatic enrolment has seen UK workplace DC pension schemes’ assets increase from around £200bn in 2012 to over £500bn today (Chart 2.3). They are expected to double to over £1tn by 2030. Box 2.1 sets out how UK DC schemes operate.

11. However, there is evidence that UK DC schemes invest relatively little in less liquid assets. Their members may, therefore, be missing out on the potential benefits that such investments can bring. For example, over four-fifths of UK DC pension funds’ investments are in mostly listed equities, and corporate and government bonds, which represent only around 20% of the UK’s assets and 30% for other advanced economies. Listed companies are typically larger than other companies, so their share of turnover is higher (accounting for a third of the employees and 43% of turnover for all UK companies) despite representing only ~0.33% (or around 1,500 of the 450,000) companies with more than 5 employees in the UK.

**References:**
- Automatic enrolment is a UK government initiative, introduced in 2012, that requires all employers (even those who have just one member of staff) to automatically enrol certain staff onto a pension scheme and make contributions towards it.
- See: ‘12P Strategy Overview of the Future’

TABLE 2.1: IMPACT OF ADDING LESS LIQUID AND ILLIQUID ASSETS TO A 60/40 PORTFOLIO (9/30/2004-12/31/2018)

<table>
<thead>
<tr>
<th>Table 2.1: Impact of Adding Less Liquid and Illiquid Assets to a 60/40 Portfolio (9/30/2004-12/31/2018)</th>
<th>Return</th>
<th>Volatility</th>
<th>Sharpe Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks/bonds</td>
<td>6.7%</td>
<td>8.58%</td>
<td>0.62</td>
</tr>
<tr>
<td>Private equity (PE)</td>
<td>55/35/10</td>
<td>7.5%</td>
<td>8.55%</td>
</tr>
<tr>
<td>Private debt</td>
<td>50/30/20</td>
<td>8.2%</td>
<td>8.56%</td>
</tr>
<tr>
<td>Private real estate</td>
<td>55/35/10</td>
<td>7.1%</td>
<td>8.09%</td>
</tr>
<tr>
<td>Blended portfolio (PE/loans/real estate)</td>
<td>50/30/20</td>
<td>7.4%</td>
<td>7.62%</td>
</tr>
</tbody>
</table>

The hypothetical 60/40 portfolio is represented by the S&P 500 Index and Bloomberg Barclays U.S. Aggregate Bond Index. Private equity is represented by the Cambridge Associates U.S. Private Equity Index. Private real estate is represented by a 50/50 allocation to the NFI-ODCE Index and the Gilberto-Levy Commercial Mortgage Index. Private debt is represented by the Cliffwater Direct Lending Index.

Sharpe ratio is an asset’s excess return (the amount over the risk-free rate) divided by the standard deviation of excess returns. A higher value generally signifies a more attractive risk-adjusted return. Past performance is not indicative of future results. This data is for illustrative purposes only and is not indicative of any investment. An investment cannot be made directly in an index. Source: ‘Liquidity Paradox’, FS Investment Solutions (2019).
12. UK DC schemes’ investment in less liquid assets is also low relative to both UK DB workplace schemes and DC schemes in some other countries, such as Australia, which are both much more mature markets. The 2020 Pension Changes Survey found that two-thirds of UK DC providers had no direct investment in less liquid assets in their default arrangements. The rest only invested 1.5%-7% of their portfolios in less liquid assets, the majority of which were property-related.30 The DC Future Book 2020 found that average allocations of Master Trust default strategies 20 years prior to retirement of only 1% to infrastructure and 0.3% to private equity.31 In contrast, ONS data show that UK private DB schemes have an average 5% allocation to real estate and a further 4% to unlisted equity.32 Australian superannuation data, which cover mostly DC pension schemes, indicate allocations of 8% in real estate, 6% in infrastructure and 4% in unlisted equity investments.33 And both Canadian and Australian DC schemes have signalled their intentions to increase their allocation to less liquid assets to support the needs of their members.

13. Investment in less liquid assets is also not evenly spread across UK DC schemes. Whilst investment in less liquid assets by DC schemes is growing in the UK, it is largely confined to large providers such as National Employment & Savings Trust (NEST) or schemes that also benefit from being associated with large DB schemes, such as Universities Superannuation Scheme (USS). NEST plans to raise its private market holdings to 15% in Q1 202234 and USS has permitted DC members in their growth fund (default for younger members far from retirement) to access private market investments that are typically reserved for DB schemes that have a much larger assets under management (AUM) basis.35 Both schemes are sophisticated, have in-house investment management teams, and benefit from strong, predictable inflows and no constraints around unit-linked rules. They also have greater bargaining power to enable bespoke platform solutions with their platform provider and asset managers on costs and fees and have fewer commercial constraints, compared to the vast majority of DC schemes.

14. The differing approaches to investment in less liquid assets means that many DC pension savers with similar investment needs may see potentially different outcomes for their retirement income simply because of the scheme they happen to be in, which would not be a desirable outcome.

2.3 BARRIERS TO DC SCHEMES’ INVESTMENT IN LESS LIQUID ASSETS

15. The low level of DC schemes’ investment in less liquid assets clearly suggests the existence of barriers. We have focussed on developing solutions to the following four barriers.

16. Excessive focus on cost, rather than long-term value for members. As the DC pension industry has grown, it has sought to ensure that costs are low, supported by the implementation of the DWP charge cap, among other things. This was important against a backdrop of legacy products that had relatively high cost without necessarily generating sufficient value for members. However, as the industry matures, an excessive focus on cost alone could become a missed opportunity to secure long-term value for members in the future.

17. Lack of scale. The DC market is characterised by a long tail of small schemes, which makes longer-term investments less accessible for the majority of them. These schemes are a key reason why a continued focus on cost has been necessary and could explain why investment by UK DC schemes in longer-term assets is lower compared to DB schemes and some other jurisdictions.

18. The greater challenge of managing liquidity when investing in less liquid assets. Increased investment in less liquid assets increases the importance of robust liquidity management, given that many of these assets cannot be bought and sold daily.

19. The need to broaden the opportunities to invest in less liquid assets to a wider range of investors. There are a range of ways to invest in less liquid assets, and all of them play important roles in meeting the needs of different investor groups. However, it is important to broaden the opportunities to invest in less liquid assets to a wider range of investors, including DC schemes and retail investors.

20. The next four chapters of this report set out proposed solutions to these barriers, that will help create an environment in which DC schemes can take the appropriate long-term opportunities for their members. Implementing these solutions will require action by and collaboration between a broad range of industry and official sector stakeholders.
Box 2.1. How do UK DC schemes work?

1. There are two types of pension schemes in the UK, Defined Contribution (DC) and Defined Benefit (DB). The Working Group has focused on the former.

2. DC schemes work by building up a pot of money for a member based on the amount of money paid into the pension and the investment returns on the accrued pot. It is the trustee’s responsibility to grow this pension pot for their members sufficiently to fund their life after work.

3. Providing someone is earning enough (over £10,000) and is old enough (aged 22 to State Pension age) they will be enrolled into their company pension when they start with a new employer. However, no such automatic system is in place for the self-employed.

4. Each employer must have a company pension scheme in which to enrol its staff. Employers choose their pension either directly or by opting to use the services of investment consultants.

There are two types of DC schemes:

- A single employer scheme - these are run by a board of trustees who make decisions about the scheme with help from advisers. They are specifically run for the employees of the particular employer.

- A multi-employer scheme – these schemes are often run on a commercial basis. They are either Master Trusts (with oversight by a board of trustees) or contract-based schemes (with oversight from Independent Governance Committees). Decisions are made for the good of the members, but this will be a more generic approach.

5. In both cases, unless members choose otherwise, they will be invested in a default arrangement. This is a fund, or collection of funds, where members’ and their employer’s contributions are invested. Whilst schemes often offer alternative investment options, it is widely recognised that the majority of members will not make their own investment decisions.

6. Employers who want to change a multi-employer scheme would typically do so with the help of an Employee Benefit Consultant to help them choose which scheme in the market is best suited to their members. They will weigh a number of factors including the cost, default investment, as well as the level to which the scheme will help members save for retirement.

3. Shifting the focus to long-term value for DC pension scheme members

3.1. AN EXCESSIVE FOCUS ON COST

1. DC schemes are expected by DWP and TPR to focus on long-term value for their members (see Box 3.1). However, the evidence we have gathered suggests that there is an excessive focus on cost in the industry, rather than long-term value, which is perceived to be the main barrier to DC schemes’ investment in less liquid assets. This was raised repeatedly in our external engagement.

2. We believe it is vital to shift the focus decisively to long-term value for members and develop suitable products that will enable schemes to access a wider range of investments, which may offer the opportunity to improve member outcomes in retirement.

3. We, therefore, welcome DWP, TPR and FCA initiatives to shift the industry’s focus towards long-term value for members (see Box 3.1). Long-term value for members is harder to measure than cost and so we also support the TPR and FCA’s commitment to explore the creation of a framework of metrics for measuring value for money to enable trustees and Independent Governance Committees (IGC) to assess and compare value for money on a consistent basis. The intention is for Value for Money (VFM) assessments to be publicly available and for regulators to be able to use the data to further drive VFM in the DC market. Investment performance (over suitable time periods and not short-term focussed) is a key pillar of the framework, and will have a role in demonstrating the relative value delivered through different investment strategies, including those with greater allocation to less liquid assets.

4. However, other regulatory measures such as the DC charge cap, whilst important, send mixed signals and there is a risk that an excessive focus on cost is becoming entrenched.

5. The charge cap limits the amount DC schemes can charge members for such things as asset management, administration and communications to 0.75%. Since the introduction of automatic enrolment, several million low and middle-income workers have been placed into pension saving for the first time and, against a historic backdrop of high charges, the cap has encouraged competition around fees and resulted in lower charges for members.

6. However, some members of the Group believe that even though trustees have a fiduciary duty to monitor overall value for members, the charge cap has encouraged an excessive focus on minimising costs and an environment in which every basis point is fought over (and, heard in our external engagement, business can be lost over). This is exacerbated by VFM requirements often being interpreted as a need to lower costs. Whilst trustees oversee the management of the scheme, it is Plan Sponsors that drive the focus on price. They, in particular, do not place enough emphasis on overall returns, net of fees, to the detriment of DC members. This is particularly acute with respect to investment into less liquid assets, which typically come with higher investment costs than public markets.

7. We recognise the important role of the charge cap in protecting members’ interests and supporting fee competition. It is equally important that it does not directly or indirectly put schemes off investment decisions that are in members’ best long-term interests.

8. The impact of this focus on cost is particularly pronounced with respect to performance fees and the principles around them. These are fees that are paid when an asset manager exceeds pre-determined performance targets. This means that they are only paid when returns cross an agreed threshold and represent a profit share. Such approaches are common to many, albeit not all, less liquid global asset classes. And some investors see performance fees as an important way to create an alignment of interest between investors and asset managers, and better link the remuneration of the asset manager and the value they add.
9. Many DC schemes, however, expressed a number of concerns around performance fees and their current treatment within the charge cap. Some are sceptical about the value and necessity of such fees and were reluctant to counterintuition about the. Performance fees are also difficult for DC schemes to administer, given members move in and out of funds, meaning periods of poor or strong performance are burdensome to assign and charge members for. Moreover, the prevalent performance fee methodology - with fees as profit shares often accruing after return of capital and when a certain hurdle rate is achieved - may present challenges for different cohorts of investors. In particular, instances could arise where an investor cohort pays the performance fee for an investment return achieved for a previous investor cohort.

10. In principle, many DC schemes may have sufficient theoretical headroom under the charge cap to invest a higher proportion of their assets in the subset of less liquid assets for which performance fees are commonly paid. For example, DWP’s recent Charges Survey showed average large DC Master Trust charges in the region of 0.4%, well below the cap of 0.75%. This is particularly the case for larger schemes, whose scale gives them greater bargaining power to negotiate lower fees. But even where there is such headroom, in practice, the focus on cost means there is relatively limited room for change and little incentive for schemes to be the first to invest in less in liquid assets, given the associated higher fees. A stronger than expected performance could also result in a larger than expected performance fee, potentially leading to a breach of the cap, with commensurate legal and financial risks for the trustees.

11. Finally, some DC schemes also expressed concern that any future lowering of the 0.75% charge cap set out above. It reduces their appetite to invest in less liquid assets, where they would be committed to the asset and corresponding fee agreement for the long term.

12. The recent DWP consultations around smoothing performance fees are a step in the right direction and we welcome DWP’s consideration of this issue. However, without more material reforms of how performance fees are treated under the cap, there is unlikely to be a material increase in DC scheme investments in less liquid strategies that typically incorporate performance fees. The smoothing proposals do not resolve the fundamental challenge, which is that trustees cannot guarantee, ex ante, that the scheme’s charges will be within the cap. But as noted above, even if the charge cap were changed significantly or lifted altogether, the commercial environment based on competition on cost and cost alone could persist.

13. Our engagement with DC schemes has also highlighted how some less liquid assets may also attract costs and charges that are different to the costs that arise when investing in listed equity. DC schemes - particularly mid-scale schemes, which do not have significant bargaining power - have also identified the level and disclosure of such other fees, including performance fees, and the broader terms and conditions they face as significant operational challenges.

14. Those offering vehicles allowing investment in less liquid assets will need to define fees and costs as either ‘administration charges’ or ‘transaction costs’. While the former are in scope of the charge cap, the latter are not. Less liquid assets are likely to have more complex cost structures than listed assets, which makes defining what category certain costs sit within more challenging. The example of property management costs can be illustrative here: providers and managers had difficulty reconciling these costs with the definition of either an administration charge or a transaction cost, and their status had to be determined subsequently in guidance from DWP.

15. While it may not be possible or desirable to develop guidance covering every potential fee, cost or terms and conditions, greater consistency on more typical examples would support a more consistent approach in the market. This could build on work by the Investment Association, which has developed a series of templates designed to assist the FCA in identifying diverging terms for the constitution of authorised funds.

16. Our discussions of the potential solutions to the barriers set out above have focussed on considerations of how to better fit performance fees into the charge cap, how to shift the focus of trustees and investment consultants from the cap with respect to fee competition and protecting members’ interests. But this may not be practicable. There is widespread agreement on the need for innovative industry solutions for reconciling investment in less liquid assets with performance fees. This could include the development of new high-level principles and methodologies for performance fees for DC schemes in certain areas, such as:

- principles for typical hurdle rates for performance fees across different asset classes;
- accrual methodologies for performance fees;
- linking performance fees to realised profits;
- considerations for circumstances where caps on performance fees might be appropriate, and incentivising the development of alternative fee methodologies such as ‘1 or 30’.

17. We recognise that the issues raised by the proposal require further consideration and that amendments to the charge cap should not be made lightly. Our engagement has identified a lack of common understanding amongst stakeholders and that there are few forums available to facilitate cross-industry dialogue. We believe that an industry forum can help overcome this and also provide a venue for the development of proposals that would permit an alternative treatment of performance fees under the cap.

18. The industry has a broader role to play in shifting the focus towards long-term value for members. In particular, we believe that investment and employee benefit consultants and asset managers should be bold and more innovative in bringing the best ideas and new products to DC clients to help maximise value after allowance of costs. Consultants should bring the experience, innovation and creativity that they have demonstrated in the DIB market to the DC market.

19. Trustees should and do, generally, act in their members’ interests, but they and their employers should redouble their efforts to take longer-term about the future of their DC arrangements and the employer’s desire to retain or outsource investment responsibility. Increasing investment sophistication requires increased levels of governance. For some employers and schemes below a certain size, such investment arrangements may be more efficiently executed through a Master Trust-type arrangement.

20. Almost all DC savers are double-defaultr. This means that they make no decision over the DC scheme into which they save and make no decision about the investments that scheme makes. Such low levels of engagement with investment decision-making increase further the importance of trustees’ duty to act in the best financial interests of members. More generally, we would encourage trustees to consider how they can use their governance budgets more effectively to maximise value to member outcomes. This is likely to become easier as schemes achieve scale (see Section 4).

21. Most schemes recognise the potential value of less liquid assets, but felt that greater support for trustees on the practical aspects of investing in less liquid assets and their execution, including sharing experiences and best practice, was more of a priority. We, therefore, encourage industry bodies to develop further supporting material.

22. Feedback from those schemes that have already allocated to less than investment frameworks that are complex and resource intensive where these are bespoke investments. There is obvious benefit to reducing some of the legal barriers to making an allocation and the development of a more streamlined approach for the industry could be beneficial.

23. Many members of the Group believe that a stronger regulatory ‘guardian’ role is required to facilitate greater investment in less liquid assets, given the barriers.

24. Uncertainty regarding how regulators and government agencies that oversee DC investment view less liquid investments was consistently raised by DC pension schemes as a barrier. We believe that a clearer statement from regulators on expectations and tolerance levels with respect to less liquid assets would address this concern. We therefore welcome the statement from DWP and TPR in this report (see Box 3). Their statement should also inform and help build on their ongoing and future policy work set out in the box to reinforce a shift in schemes focus from cost to overall value.

25. We are aware that TPR is currently considering how it will respond to feedback it received on the Draft Code of Practice that it published for consultation in March 2021, in particular, in relation to its proposal that ‘unless there are exceptional circumstances, governing bodies should ensure no more than a five of scheme investments are held in assets not traded on regulated markets’. We acknowledge the useful context that TPR provided in relation to this draft proposal in the blog they published on 28 May 2021 and that, in the interim response to the code of practice consultation they published on 24 August 2021, they indicated that their ‘intention had been, and remains, to protect members of poorly run, and typically small, schemes from investments in poor quality or inappropriate assets’. We understand that TPR is considering what adjustments might be appropriate and exploring options for achieving their original policy objective whilst allowing schemes with liquidity risk management plans and prudent investment strategies to maintain exposures to unregulated assets. We believe that investment limits are an inappropriate tool in this instance and that it would be helpful if TPR could provide more guidance to trustees on the use of less liquid assets.

---


---
27. Many members of the Group see less liquid investments as involving more work and incurring higher costs, rather than an asset class in their own right. For example, they advocate having a requirement to include a policy statement on less liquid assets within the Statement of Investment Principles (SIP) and/or Chair’s Statement with a read across for contract-based pensions explaining why a scheme has not invested in less liquid assets if they have decided not to. This reflects views expressed by many commercial, multi-employer pension providers in particular as a way to help encourage the first mover in a very cost constrained market. DWP will consider whether such a ‘comply or explain’ policy, amongst other options, is sensible in the long term for pension schemes, as these wider policy recommendations are taken forward.

28. Some within the Group, predominantly those representing single employer schemes, expressed concern that such an approach would be impractical and would simply add to the heavy compliance burden already faced by DC schemes and trustees – for example, on ESG. They also felt it would adversely affect fiduciary independence and potentially be counterproductive with respect to investment in less liquid assets. There was, therefore, no consensus around implementing such a regulatory change to achieve this outcome.

RECOMMENDATIONS

a. DC scheme trustees are the ultimate decision maker on investment for most of their members and need to focus on long-term value for them. Where appropriate and in their members’ interests, trustees should actively consider how increasing investment in less liquid assets (including through newly created LTAFs) could generate greater value for their members, and monitor long-term returns using robust metrics.

b. Consultants play a key role in supporting DC schemes in making investment decisions. Consultants should therefore:
   (i) endorse the objectives of this work; and
   (ii) integrate allocations to less liquid assets in their recommendations to their DC scheme clients when appropriate.

c. Recognising the challenges associated with investing in less liquid assets, trade bodies should further raise awareness of the benefits and operational considerations of investment in less liquid assets, including on how to manage the risks associated with these investments.

d. To support DC schemes’ investment in less liquid assets – particularly, mid-range schemes which do not have significant bargaining power – the legal profession, asset managers, DC schemes and investment consultants to work together in the appropriate forum to consider:
   (i) appropriate methodologies to accommodate performance fees within the charge cap, and
   (ii) appropriate terms and conditions, more generally. Industry should engage with the official sector on the results of their work.

e. The charge cap plays an important role in protecting pension scheme members, but can also risk contributing to a focus on short-term value for members, and not on the long-term value for members. Where appropriate, DWP and TPR should consider ways to proactively communicate their supportive messaging on investment in less liquid assets, as they have in this report (e.g. publishing additional guidance for trustees on investing in less liquid assets).

f. To shift the focus from cost to value and make an impact that is only possible through collective action, DWP and TPR should consider ways to proactively communicate their supportive messaging on investment in less liquid assets, as they have in this report (e.g. publishing additional guidance for trustees on investing in less liquid assets).

Box 3.1. DWP and TPR statement on investment in less liquid assets

1. The following statement sets out a joint position of DWP and TPR in relation to investments in less liquid assets by DC schemes that they regulate. It also summarises existing efforts by DWP to enable DC schemes to invest in less liquid assets, including those designed to shift the focus from cost to long-term value for members and increase scale. Annex 1 sets out a summary of existing investment regulations.

2. DWP and TPR are committed to addressing the excessive focus on cost as the only determinant of value for money. A paradigm shift is required on the part of all participants in the DC market to move beyond ‘low cost’ and both organisations should explore ways to correct this market failure.

DWP and TPR position

3. The primacy of members’ financial interests was confirmed by the Law Commission in 2014 and 2017 as central to the objective of the SIP. This provides a framework for all DC schemes and trustees to consider these opportunities, should consider the options for addressing this and should consider what advice and other input they need to help them govern the scheme’s investments effectively.

DWP initiatives

7. Since automatic enrolment was introduced almost a decade ago, the DC market has grown rapidly in terms of DC scheme membership and total assets held by DC schemes. This growth is projected to continue in years to come.

8. Whilst the DC market in the UK is relatively immature, DWP is aware of many DC schemes that are looking to evolve their investment strategy as they grow to continue to meet the needs of their members. The government wants to support DC schemes to invest in a diverse range of asset classes and ensure they do not encounter barriers to allocation to assets that they believe will offer members potential for greater diversification and, ultimately and primarily, the potential to deliver better outcomes for savers.

9. DWP has taken several steps to enable investment in less liquid assets by DC schemes. This has culminated in 5 new regulatory measures which will come into force on 1 October 2021, subject to imminent scrutiny by Parliament.

10. The first is to shift the focus in the DC market from costs to overall value for money. At present, schemes are only required to publish the costs and charges associated with their various funds but from 1 October 2021, schemes must also publish net returns. The government believes that investment returns, which can vary significantly more than charges, are a far greater determinant of member outcomes. We hope that this will drive competition on the basis of overall value.
11. As announced at Budget 2021, the regulations will also allow schemes greater flexibility around performance fees. These fees, which are most common in private equity and venture capital, are hard to administer as, unlike most charges, their value is difficult to predict in advance as the amount payable depends on the performance of the underlying investments and they are often not payable until the end of the life of a fund, at which stage the members that benefitted from that performance may have left the scheme.

12. The new regulations will allow schemes an exemption from the overarching requirement to pro-rata charges in-year specifically and only in the case of performance fees as well as the ability to smooth performance fees over five years. Both measures will assist trustees in administering performance fees for their scheme and give them greater confidence to invest in asset classes that have variable fee elements, such as private equity and other alternatives, by reducing the likelihood of an unpredictable charge cap breach.

13. In addition, the regulations also seek to promote further consolidation of the DC market by improving standards of governance. More than 1,000 schemes, which have less than £100m in assets and have been in existence for at least three years, will be required to go through a new value for members assessment. Trustees of these schemes must assess whether or not their scheme offers value for members that benefitted from that performance may have left the scheme.

14. Following this holistic assessment of value, schemes must declare the result to members. If the scheme determines that it does not offer value for money, the trustees must either lay out that they will take immediate steps to improve the scheme or that they will wind-up or transfer members to another scheme.

15. We anticipate that this assessment, which will come into effect from 1 October 2021, will drive a number of schemes that offer sub-optimal value to consolidate into larger, better-governed, better-performing schemes.

16. On 21 June 2021, the government announced that we would seek to go ‘faster and further’ with consolidation of the DC market. We believe that scale in the DC market will help drive better value for money for all members. Scale is essential for DC schemes, and DC savers, to be able to access a wider range of investment opportunities, including productive finance. The Working Group has heard, as has DWP through various consultations, that without the ability to negotiate on fees, to be able to commit a minimum amount to an unlisted investment and to be able to understand and develop expertise in private markets, productive finance assets will remain out of reach for DC schemes.

17. The call for evidence, launched on 21 June 2021, seeks to assess how to overcome the barriers to greater consolidation and understand the benefits that can be achieved in terms of member outcomes. The Department plans to respond with further policy measures in this area later this year.

4. Building scale in the DC market

1. A meaningful, diversified allocation to productive finance and less liquid assets is only currently possible for pension schemes of a certain size. The UK DC pensions market is fragmented. Despite significant consolidation over the past decade, it is still a relatively immature market. In January 2021, there were still around 1,560 DC schemes on the TPR’s register with more than 12 members, accounting for £87.5bn of assets (Chart 4.1). Of these, 760 have less than 100 members, 660 have between 100 and 5,000 members and 140 have more than 5,000 members.

2. Evidence suggests that as DC schemes achieve scale, they are more likely to increase their investment allocation to less liquid assets as this becomes more efficient through economies of scale. As noted above, one benefit of scale, particularly for DC schemes linked to large DB schemes, is that it increases their bargaining power in negotiating lower fees when investing in less liquid assets. In contrast, smaller schemes may not always have the resources to support investments in less liquid assets. The benefits of consolidation and scale may apply in the DB market as well as the DC market. They may be realised via insurance buy out or a dedicated consolidation vehicle.

38. For comparison, at the end of 2020 there were 38 authorised Master Trusts with total assets (excluding hybrids) of £25.8bn. And at the same period in Australia there were 179 pension schemes of more than 100 members with total assets of over £1tn. https://www.pensionspolicyinstitute.org.uk/media/3112/20190325-dc-scheme-investment-in-illiquids-high-res.pdf and https://www.thepensionsregulator.gov.uk/-/media/tpr/documents/consultation-papers/call-for-evidence-to-the-consolidation-and-understanding-the-benefits-that-can-be-achieved-in-terms-of-member-outcomes.pdf?la=en

39. As noted above, one benefit of scale, particularly for DC schemes linked to large DB schemes, is that it increases their bargaining power in negotiating lower fees when investing in less liquid assets. In contrast, smaller schemes may not always have the resources to support investments in less liquid assets. The benefits of consolidation and scale may apply in the DB market as well as the DC market. They may be realised via insurance buy out or a dedicated consolidation vehicle.

40. As noted above, one benefit of scale, particularly for DC schemes linked to large DB schemes, is that it increases their bargaining power in negotiating lower fees when investing in less liquid assets. In contrast, smaller schemes may not always have the resources to support investments in less liquid assets. The benefits of consolidation and scale may apply in the DB market as well as the DC market. They may be realised via insurance buy out or a dedicated consolidation vehicle.

CHART 4.1: SINGLE EMPLOYER DC SCHEMES’ CONSOLIDATION

Source: DC trust scheme return data, 2020-2021, TPR.
3. The consolidation of the DC market is likely to accelerate over the next few years. This further consolidation will be driven, in part, by new regulations, which will require trustees of schemes with less than £100 million in assets to justify their continued existence via new value for member assessments. Consolidation will be accelerated further should the proposals in the recently launched DWP call for evidence on the case for greater consolidation of schemes with between £100 million and £5 billion of assets be introduced.  

4. This further consolidation may facilitate greater investment in less liquid assets over time, particularly by Master Trusts, as they increase scale. We agree with the Pension and Lifetime Savings Association that the interests of members of smaller schemes must be fully taken account of during this process.

RECOMMENDATIONS

- A lack of scale is a key barrier for DC schemes in investing in less liquid assets. Increasing scale is likely to facilitate greater investment in such assets, for example, by raising schemes’ bargaining power in relation to their fees and their ability to draw on the relevant expertise in making such investments. To address the barriers from the lack of scale in the long tail of smaller DC schemes, DWP should continue with a DC schemes consolidation agenda, where it is clear that schemes are not providing value for members.

- DC schemes’ trustees to assess their scheme’s ability to deliver value and access a diversified range of asset classes at its current scale in their consideration of whether to consolidate.
5. A new approach to liquidity management

1. Greater investment in less liquid assets increases the importance of robust liquidity management, given that these assets cannot be bought and sold daily. Some DC schemes have already found a way to manage liquidity while investing in less liquid assets. And we think that more schemes can find approaches that enable them to invest in less liquid assets as part of a diversified portfolio, while also meeting the liquidity needs of DC scheme members.

2. One of the main conclusions from our work is that despite the perceived challenges around liquidity management, it does not pose insurmountable barriers to DC schemes’ investment in less liquid assets. The daily dealing system can accommodate investment in such assets, if DC schemes take a more holistic view and invest in less liquid assets as a part of a diversified portfolio, for example, within DC schemes’ default arrangements. This would mean managing liquidity primarily at a DC scheme level rather than at fund unit level.

3. Trustees would need to get comfortable with this approach. As part of that, they would need supporting fund structures, including a suitable redemption policy and notice period for open-ended funds or investing via a closed-ended structure. For example, the LTAF has been designed to address liquidity mismatch at an underlying fund level. This section considers liquidity management at both DC scheme and fund level, and outlines the key features of the LTAF, given our work in support of the FCA’s consultation.

5.1 Liquidity management at DC scheme level

4. On the surface, the daily dealing nature of the current DC system seems ill-suited to less liquid assets that are not tradable in that timeframe (see Box 5.1 on the challenges of liquidity management). However, our engagement with a range of industry stakeholders indicates that moving away from a daily dealing format within DC schemes is neither feasible nor necessary in order to accommodate less liquid exposures. And in fact, even moving away from daily to, say, weekly dealing would not make a difference, because a mismatch between that frequency and a much longer maturity of the underlying assets would still remain.

5. The lack of feasibility reflects the following:

- The existing operational architecture used by DC schemes is built around daily dealing. This principally manifests itself in the way DC member record-keeping systems have been designed. Changing this would require substantial changes to premium collection, dealing systems, cash flow modelling, administration systems, transfer processes, retirement processes, terms and conditions and member communications to name but a few. The cost for the industry to completely overhaul the entire system and integrate the change to non-daily dealing would be prohibitive, at least in the current environment, in which the decisions around allocations to less liquid assets hinge on whether schemes feel comfortable increasing costs by as little as 0.01% and relatively small proportions of portfolios are allocated to less liquid assets.

- Pension scheme members have an existing expectation around how long they may wait to receive their money and consumers generally are used to receiving instant access to services, both of which make a change to non-daily dealing challenging. Some members in pension default funds may not have chosen to invest in less liquid assets and may want to access their money quickly.

- There are also certain issues caused by existing regulation – for example, the requirement for premiums to be paid to a pension scheme by the 22nd of the month following the notice period for open-ended funds. This means having indirect exposures to such assets within a fund of funds structure, with one (option 2) or several (option 3) asset classes. Such indirect exposures help manage liquidity due to the strong, predictable, positive cash flows and significant holdings of liquid assets within a broader default arrangement.

5. Alternatively, the only source of cash flows would come from reallocation across members within a default arrangement.

6. However, if DC schemes decide that investment in less liquid assets is in their members’ interests and choose to allocate to LTAFs or other non-daily dealing funds, they could do so within the current daily dealing system. They would need to overcome some operational barriers, in particular around pricing such assets, but none of these barriers are, in our view, insurmountable. Further important considerations that schemes would need to address to implement this approach to liquidity management are outlined below. None of them require a radical overhaul of the daily dealing environment.

7. DC schemes can meet the liquidity needs of their members, while investing in less liquid assets, if those investments are a part of a broader portfolio and, therefore, liquidity is managed primarily at a DC scheme level. The industry participants we have engaged with are confident they can manage liquidity, because they are likely to invest in these assets as a part of a diversified portfolio within their default arrangements (Diagram 5.1). This means having indirect exposures to such assets within a fund of funds structure, with one (option 2) or several (option 3) asset classes. Such indirect exposures help manage liquidity due to the strong, predictable, positive cash flows and significant holdings of liquid assets within a broader default arrangement. This is different from direct exposure to an illiquid fund (option 1), where the only source of cash flows would come from reallocation across members within a default arrangement.

Diagram 5.1: Allocating to less liquid assets within a DC default arrangement

8. Trustees of larger schemes, often having both a DB and a DC component or greater in-house expertise, are more likely to manage liquidity internally, while smaller schemes may need to rely on an asset manager for their liquidity management needs. At the moment, given a large number of relatively small DC schemes, in the vast majority of cases trustees delegate liquidity management to their provider or asset manager and expect them to manage the fund appropriately. But this could change as the market evolves. And in either case, trustees remain accountable, so they will need to be comfortable with liquidity management and the governance around it.

---

Operationalising liquidity management

9. When liquidity is managed through a fund of funds structure, in ‘business as usual’ state, members’ liquidity needs could be met through inflows to the default arrangements. This requires understanding the member base and their liquidity needs. Introducing a less liquid asset to a default arrangement would create some challenges around asset allocation drift (i.e. the movement away from the allocation targets) and portfolio rebalancing (Diagram 5.2). DC default arrangements operate a strategic asset allocation deemed suitable for members who make no investment choices. These allocations grow at different rates and hence require rebalancing to ensure they remain consistent with what is deemed appropriate for the members. Scheme rebalancing varies both in frequency and in tolerance to drift. Schemes will use both new contributions and sales and purchases of holdings to rebalance. This exercise becomes more challenging when there is an illiquid component such as an LTAF, because it is no longer possible to simply sell an LTAF holding at short notice to rebalance. Rebalancing on a daily basis is less challenging when investment in less liquid assets is done through a listed investment company structure, such as an investment trust.

10. Managing liquidity in extreme and unexpected events is more challenging. In stress events, which could be either at scheme-level (for example, a sudden mass transfer out) or macro-level (for example, a sudden decline in equity markets), the key to liquidity management is rebalancing a portfolio. Regardless of the nature of a shock, it would make a DC scheme overweight in less liquid assets relative to the strategic asset allocation targets. However, a number of these events can be controlled with a degree of patience around timing.

5.2. BUILDING TRUSTEES’ CONFIDENCE

11. Trustees retain ultimate responsibility for meeting members’ liquidity needs. Therefore, for DC schemes to invest (more) in less liquid assets, when they judge this to be in their members’ interests, trustees will need to be comfortable with this new approach to liquidity management and governance around it. Three elements could help with that: stress testing, supportive fund structures and an appropriate approach to pricing them.

Stress Testing

12. Investing in less liquid assets through non-daily dealing funds will require DC trustees to find their level of risk tolerance and understand the risk of temporary deviations from their asset allocation targets. Trustees (or asset managers managing liquidity on their behalf) would need to decide on the extent and duration of such deviations. To avoid becoming a forced seller of less liquid assets, schemes should avoid setting hard allocation limits and allow for some flexibility to be short term overweight or underweight a less liquid asset class.41

13. Stress testing and scenario analysis could help trustees get more comfortable with liquidity management around their portfolios. These tools are key to understanding how a scheme would cope with less liquid assets and source liquidity in the event of certain macro shocks, policy changes or large-scale member behaviour changes. This means considering not only the current or historic cash flows, but also how they are likely to evolve in the future and the uncertainty around that. Insight from modelling based on member demographics and behaviour can mitigate some of these risks by allowing the provider to build up a picture of likely short to medium term liquidity needs. Typically, such modelling already exists, and only minor changes would be required to accommodate the additional less liquid asset classes. Trustees, providers and asset managers need to consider the specific nature of each private market asset class and the impact on the overall liquidity of the scheme.

14. Possible scenarios schemes could consider include:
   a. A sudden stop of inflows, for example, due to government pausing auto-enrolment, a mass redundancy event at scheme level, idiosyncratic issues with the scheme’s employer client base (for example, loss of a large employer with a big liquid exposure), or a provider pulling back from the market and only servicing closed-book schemes.

DIAGRAM 5.2: ILLUSTRATION OF PORTFOLIO REBALANCING

<table>
<thead>
<tr>
<th>Target allocation</th>
<th>Allocation drift</th>
<th>Target allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid fund 1</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Liquid fund 2</td>
<td>25%</td>
<td>20%</td>
</tr>
<tr>
<td>Liquid fund 3</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Liquid fund 4/illiquid fund 1</td>
<td>25%</td>
<td>26%</td>
</tr>
</tbody>
</table>

For a portfolio of solely liquid funds
sell units in overweight funds and buy units in underweight fund as little as 1 day or purchase units in underweight funds at receipt of next monthly contributions

For a portfolio containing an illiquid fund
sell units in overweight liquid funds and buy units in underweight illiquid fund at the next dealing point, potentially several months away

11. Given the heavy allocation to listed assets and infrequent nature of private asset valuations, the greatest risk to a scheme’s strategic asset allocation moving dramatically from target comes from sudden and large market drawdowns in the listed component of the portfolio, which will result in the scheme being heavily overweight on its less liquid portfolio.

15. Outside such scenarios, the age 55 access limit makes a run on DC pensions unlikely, because it acts as an in-built safety mechanism by preventing member withdrawals at an earlier age, although transfers away are still possible. We considered ways of mitigating some of these risks and specifically looked at proposing universal notice periods for transferring from one workplace pension to another DC, which was thought through this was unnecessary as such transfers already had significant notice periods and took time to complete.

16. The experience of property fund suspensions in the wake of the pandemic-induced market falls in March 2020 is a good indicator, as providers had mixed appetite for providing liquidity, aligned with the demographics of their membership. For those providers with a large demographic of younger members further from retirement, they were unlikely to be too exposed to significant member withdrawals and could therefore offer liquidity through the period of suspensions.

Appropriate fund structures

17. To be more confident about investing (more) in less liquid assets, trustees would also need appropriate fund structures that provide access to less liquid investments. The DC market participants we have engaged with were almost unanimous that to be comfortable with investment in less liquid assets, they need fund structures that are as illiquid as possible. This is because if trustees make a decision to allocate to less liquid assets, they want to ensure they get exposure to truly illiquid assets, in a clear and transparent fund structure that avoids the liquidity mismatches. In practice, this means the liquidity profile of the funds matching the liquidity of its underlying assets, including an appropriate redemption policy and a lengthy notice period. It also means funds that invest predominantly in less liquid assets and avoid artificially high allocation to cash. Appropriate liquidity management being built into the fund structure will also be beneficial to other potential investor groups, for example, retail investors (see Section 6).
18. There are several vehicles that could facilitate investment in long-term, less liquid assets, including investment trusts, qualified investor schemes (QIS), European Long-Term Investment Funds (ELTIF) and others. The first of these is closed-ended, and therefore has a fund structure aligned with the illiquid nature of the underlying assets. We have focused on the development of the LTAF, which could supplement other existing structures, broaden the range of investment opportunities for DC schemes and other investors, and offer dealing terms specifically designed to match less liquid underlying assets. Box 5.2 summarises the key features of the LTAF blueprint developed by the Group.

19. From the perspective of liquidity management, a key principle for the LTAF is to ensure appropriate alignment of the dealing terms and liquidity of the underlying assets to remove liquidity mismatch. This means funds are by design and definition non-daily dealing and have lengthy notice periods; i.e., a lag between the investor submitting their redemption request and receipt of redemption proceeds. This helps reduce liquidity risks associated with investment in the LTAF for individual investors and reduces financial stability risks from this fund structure. Our engagement with broader industry suggests that longer notice periods are not an issue as long as likely member behaviour is well understood.

20. LTAFs could have access to a wide range of liquidity management tools that need to be clearly and fully disclosed in the fund prospectus and marketing documentation. These tools must operate as intended throughout the economic cycle, including during stressed market conditions, and allow asset sales in an orderly manner without a discount, with an aim to avoid suspension of the LTAF as much as possible. These tools should prevent liquidity mismatches arising in normal and foreseeably stressed market conditions and remove incentives for investors to exit the fund because of liquidity concerns.

21. While supportive of the principles-based approach towards LTAF liquidity management, set out in the FCA consultation paper we think it is important to ensure a high standard is met in practice and the approach is consistent among the market participants to ensure fair treatment of consumers.

An approach to pricing less liquid funds

22. DC schemes’ members and trustees expect to have a daily price for the elements of their default funds. To be comfortable with investing (more) in less liquid assets, trustees would also need support in considering the most appropriate approach to pricing less liquid funds.

23. The need for daily pricing despite infrequent valuations is the main operational barrier for investment in less liquid assets using a non-daily dealing fund within the daily dealing system. The current daily dealing system was built with an intention to ensure that investors’ money could flow in and out, without missing market movements and the resulting opportunities for returns. As a consequence of this daily dealing environment, DC schemes have developed record keeping systems, allowing members to monitor their contributions and withdrawals and the value of their investment on a daily basis. While it is not a legal requirement, this has become an important part of DC schemes’ communication with their members.

24. Daily pricing does not mean that there needs to be a daily valuation or daily dealing in the underlying funds. But it does pose operational challenges around incorporating less liquid assets in the default arrangements, in particular, with respect to establishing the most appropriate approach to daily pricing and its implications for the frequency of valuations. Further guidance on these issues could make trustees more comfortable in investing (more) in less liquid assets.

RECOMMENDATIONS

a. To support appropriate liquidity management at DC scheme level and give trustees greater confidence in investing in less liquid assets without putting at risk their obligations to members, DC schemes will need support and guidance on liquidity management at a fund level. Therefore, in addition to the implementation of a clear regulatory framework which sets out required standards for liquidity management, we recommend that industry participants and trade bodies develop guidance on good practice on a toolkit for liquidity management at a fund level, in consultation with the FCA and Bank of England in the context of their broader work on liquidity classification for open-ended funds. This guidance should focus on appropriate ranges for dealing frequency and notice periods for different asset types, and cover the following:

   • Factors affecting the appropriate notice periods, including asset class, region, manager, size of position and strategy type, market conditions, and any idiosyncratic features of investment.

   • The potential lengths of appropriate notice periods, depending on liquidity of the underlying assets – to aid understanding of likely notice periods, but not a substitute for monitoring the liquidity profile of the fund’s portfolio. An appropriate notice period should reflect the time required to sell the required portion of a fund’s assets without a discount. We considered illustrative, hypothetical examples with the notice periods ranging between 6 and 24 months, and concluded that further work is required to develop appropriate ranges and their determinants for different asset classes (Box 5.2). This would require new analysis, while also drawing on the existing studies. For example, a recent ESMA report shows that most infrastructure and PE assets take, on average, over 12 months to sell and over 80% of industrial real estate assets take more than 6 months to sell.15 We note that the sales process also depends on whether it is a single private market fund, a portfolio of funds, co-investment strategy or a direct portfolio company. For example, the sale of a typical well-diversified private markets fund could be completed within 6 months, while a holding in a portfolio company could take around 12 months.

   • Settlement period: Notice period is the time between when an investor places a deal and the pricing point for that dealing period. Settlement period is the time it takes for monies to be received after the pricing point. The DC pensions industry commonly has a settlement period of 3–4 days. Operational delivery of LTAF exposure within a DC default becomes significantly more challenging if settlement periods are longer than that, even though a notice period could still be longer than a settlement period. This is because reinvestment of the proceeds becomes more challenging as deals often have to be pre-funded given the timings of the cash flows. The arising challenges can be addressed by ensuring that the settlement period is taken into account when setting notice periods. Efficient liquidity management requires the combination of notice period and settlement period, and industry guidance in the light of the operational challenges would be helpful.

b. Drawing on this guidance, asset managers should develop products, including LTAFs, that suit DC schemes’ needs and give trustees greater confidence in investing in less liquid assets.

c. The FCA should support this by providing information to trustees about how asset managers are required to price units, in particular in an LTAF context.

---

6. Against the backdrop of these competing demands, it may seem difficult to reconcile the needs of the DC investor and the desire to resolve liquidity mismatches at the underlying fund level.

7. One of the main conclusions from our work is that despite the perceived challenges around liquidity management, it does not pose insurmountable barriers to DC schemes’ investment in less liquid assets. The daily dealing system can accommodate investment in less liquid assets if DC schemes take a more holistic view and invest in less liquid assets as a part of a diversified portfolio.

---

**BOX 5.1. CHALLENGES AROUND DC SCHEMES’ LIQUIDITY MANAGEMENT**

1. DC scheme investment in less liquid assets generates liquidity challenges at both the scheme and fund levels.

2. At the scheme level, regardless of what a DC scheme invests in, it will have liquidity considerations that are driven by the needs and behaviours of its members and their sponsoring employer. Schemes receive regular contributions that need to be invested in a certain timeframe. DC schemes also receive redemption requests and have to honour these at short notice, for example as a member retires or chooses to move to another scheme. There is some predictability around such cash flows based on age and other member characteristics, and most DC schemes are currently cash flow positive. But, ultimately, schemes have to manage liquidity events. Master Trusts may also face the risk of an entire employer leaving a scheme, which would be a more material event and more challenging to manage (usually no longer than a 6 months’ notice period). In managing their liquidity needs, schemes will also be mindful of the liquidity profile of their investment, and how quickly they can exit a given underlying fund. So, whilst members may in general have a long-term horizon, schemes still need to manage short-term liquidity needs.

3. In practice, to avoid market timing issues this translates to DC schemes operating within a daily dealing environment, with an infrastructure that supports regular inflows and outflows from DC schemes, despite the long-term investment horizon of their members. Superficially, such an environment poses an operational challenge to investment in inherently less liquid assets.

4. At a fund level, there is a need to remove liquidity mismatches between the redemption term of an open-ended fund offers and the liquidity profile of the underlying assets. This calls for suitable fund structures, including appropriate redemption policy and notice periods for open-ended funds or closed-ended structures which customarily offer liquidity via trading the shares on the stock market.

5. For DC schemes that are contract based (via an insurer), there are also regulatory requirements that discourage an insurer from exposing its own balance sheet to a liquidity mismatch. There are also requirements that place restrictions around the liquidity profile of products insurers can offer (the permitted link rules, see Section 6.1).

6. Against the backdrop of these competing demands, it may seem difficult to reconcile the needs of the DC investor and the desire to resolve liquidity mismatches at the underlying fund level.

7. One of the main conclusions from our work is that despite the perceived challenges around liquidity management, it does not pose insurmountable barriers to DC schemes’ investment in less liquid assets. The daily dealing system can accommodate investment in less liquid assets if DC schemes take a more holistic view and invest in less liquid assets as a part of a diversified portfolio.

---

**BOX 5.2. LTAF BLUEPRINT**

1. The concept of the LTAF was first developed by the Investment Association’s UK Fund Regime Working Group in 2019 to meet the needs of DC pension schemes and advised retail clients.\(^{19}\) These needs include the ability to accept regular contributions, ensure appropriate consumer protections are in place, high governance standards, strong liquidity management, and pricing and valuation policies that meet operational requirements.

2. We have been pleased to support the recent FCA consultation on this new fund regime. We have engaged with the FCA on the key principles underpinning the regime, provided input on how best to bridge the worlds of less liquid markets and the needs of DC pension schemes, and developed a blueprint for the LTAF. We have also developed several hypothetical examples of the LTAFs, to illustrate their potential features (Table 1). They could be useful for market participants to consider when making their own decisions. That said, these examples should be treated as a hypothetical illustration rather than recommendations or suggestions.\(^{20}\)

3. **Allowing a broad range of less liquid assets**

   3.1 To ensure success for the LTAF, we think a broad range of global liquid assets by type, sector, and jurisdiction should be permissible to meet the needs of DC schemes. Except for being long-term in nature, the primary investable asset universe considered by the Group is sufficiently broad to cover a range of productive assets including private equity, venture capital, infrastructure, private debt and real estate.

4. **Aligning the fund’s liquidity with that of its assets**

   4.1 A key principle for the LTAF is to ensure an appropriate alignment of the dealing terms and the liquidity of the underlying assets. This means funds are by design and definition non-daily dealing and have lengthy notice periods.

5. **Leverage**

   5.1 An appropriate leverage threshold should reflect a balance between the fund being commercially attractive by generating sufficient returns but without being overly leveraged. This will help manage liquidity risks and hence consumer perceptions about its desirability and broader financial stability risks.

6. **Frequency of valuations and pricing**

   6.1 The frequency of valuation of LTAFs should reflect their illiquid and non-daily dealing nature. With that in mind, daily pricing requirements of the daily dealing environment in which DC schemes operate poses a challenge.

---

\(^{19}\) The final LTAF rules are yet to be published and no assumption should be made that a scheme with these features will be authorized by the FCA.

\(^{20}\) This means that the LTAF rules are yet to be published and no assumption should be made that a scheme with these features will be authorized by the FCA.
Subscription vs commitment model

11. The less liquid nature of the underlying assets means they take time to be purchased, both because the suitable investment opportunities are not always immediately available and because the complexity and due diligence involved mean transactions take time to execute. This delay will have an impact on pension schemes’ cash holdings, which will need to be considered in the context of the scheme’s wider strategic asset allocation. Schemes should be aware of the potential for cash drag and implications for liquidity management and governance around it, depending on whether the LTAF in question uses a subscription or a commitment investment model.

12. Under a ‘subscription’ model all monies are accepted by the fund at the dealing point. The LTAF manager then deals with the cash management prior to investment in the underlying assets. From a scheme governance perspective this is a straightforward option as the LTAF manager will need to manage cash ahead of investment. The scheme can make the allocation and leave the fund manager to manage the investment, deploying capital where necessary. However, a fee is payable to the LTAF manager by the scheme for managing its money in more liquid instruments ahead of investment. Schemes will need to consider whether a reduced governance burden is worth this fee. This can contribute to the ‘j-curve’ effect where the scheme’s allocation is initially a drag on performance. Based on our engagement with the broader industry, given the market’s preference for indirect exposure to LTAFs, it also means that the multi-asset fund manager would have to include cash in the LTAF as part of their overall investment picture.

13. Under a ‘commitment’ model, the pension scheme commits to supplying capital when called upon by the LTAF manager as investable opportunities arise. Responsibility for managing the money ahead of capital calls will lie with the scheme and decisions will need to be taken about how that money is managed, balancing the need to avoid cash drag with ensuring cash availability when called for (for which the scheme may be under legal obligations). The scheme will need to understand the mechanism for the LTAF manager drawing down committed capital and the timeframe under which the cash must be made available. It is anticipated this will be set out in the legal agreement between the scheme and the fund of the LTAF manager. This is a higher governance burden for the scheme, but ensures the scheme retains greater control over asset allocation and potentially reduces the fees to manage cash prior to investment.

14. An alternative, hybrid solution could involve the ‘commitment’ taking the form of a corporate action rather than a legal commitment. In this example, the LTAF would issue a request for funds up to a value and schemes get the choice whether to commit or not depending on their cash flow position at the time. The LTAF manager would only commit to the less liquid purchase if they had secured sufficient capital from their unit holders. Whilst this option could work, it does start to turn the LTAF into an open/closed-ended hybrid but might make it more usable for retail investors.

15. Market consensus suggested the commitment model may well be preferable for the larger DC schemes using a multi-asset fund, while a subscription model could be attractive in smaller schemes operating a simpler fund of funds structure. The preferred model would also depend on the scale of the market for LTAFs. A commitment approach could work for a small number of registered holders, but may not if it is distributed more widely.

41
Table 1. LTAF illustrative examples – for reference only

This box summarises some of the hypothetical examples developed by the Working Group to explore potential features of LTAFs*.

<table>
<thead>
<tr>
<th>Sustainable Infrastructure LTAF</th>
<th>SME Private Credit LTAF</th>
<th>Multi Asset Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategy</strong></td>
<td>Focuses on infrastructure assets that accelerate the transition to a net zero economy</td>
<td>Making and purchasing loans to SME businesses in the UK</td>
</tr>
<tr>
<td><strong>Asset Class</strong></td>
<td>At least 70% direct unlisted infrastructure equity</td>
<td>At least 50% direct unlisted loans Remaining in listed credit securities</td>
</tr>
<tr>
<td><strong>Geography</strong></td>
<td>UK &amp; European Union</td>
<td>UK only</td>
</tr>
<tr>
<td><strong>Expected holding period for client</strong></td>
<td>c15 years</td>
<td>3-7 years</td>
</tr>
<tr>
<td><strong>Dealing</strong></td>
<td>Commitment model – i.e. client monies are drawn down by manager when required to purchase an asset</td>
<td>Subscription model i.e. all monies are accepted by the fund at the dealing point</td>
</tr>
<tr>
<td></td>
<td>Two yearly redemptions based on audited valuation</td>
<td>Quarterly redemptions</td>
</tr>
<tr>
<td></td>
<td>Annual subscriptions</td>
<td>Monthly subscriptions</td>
</tr>
<tr>
<td><strong>Initial Lock in period</strong></td>
<td>5-year initial lock-in period</td>
<td>24 months</td>
</tr>
<tr>
<td><strong>Notice Period for redemptions</strong></td>
<td>24 months</td>
<td>6 months</td>
</tr>
</tbody>
</table>

* The illustrative examples given in the table have not been approved or endorsed by the FCA. Each application for authorisation of an LTAF will be considered on its own merits to ensure that the LTAF complies with applicable laws and requirements, including FCA rules. No assumption should be made that an application for the authorisation of an LTAF which shares features with those used in the examples would be granted.

**Dealing is irrevocable once the client makes a redemption request and the transaction price units are redeemed at the prevailing price at the time the request is executed – not when the request is made.
6. Widening access to less liquid assets

1. There are currently various ways in which investors can access less liquid assets, including through closed-ended funds and investment trusts. All of these structures play important roles in meeting the needs of different investor groups. That said, there is an opportunity to increase the range of available products, including dedicated open-ended, FCA-authorised vehicles, which might appeal to those investors that do not currently invest in less liquid assets (Box 6.1).

6.1. INVESTMENT THROUGH UNIT-LINKED FUNDS

2. Pension schemes may invest their clients' monies via a life insurance platform. In this case, the scheme becomes subject to the permitted links regulations that aim to offer consumer protection to the end retail client. This regulation limits investment in less liquid assets to 35% at the level of individual funds, which makes it one of the most significant barriers to DC schemes that may want to invest more in such assets.

3. Permitted links regulation could be a potential barrier to the distribution of LTAFs. In particular, in the UK DC pension market, a major potential distribution route for LTAFs will be via unit-linked funds. One of the most significant barriers to unit-linked funds investing more in less liquid assets, is the permitted links rules' 35% cap applied to such assets (excluding land and property) at the level of individual funds. Putting a life wrapper around an LTAF and then combining the wrapped LTAF with other life funds is likely to be the most commercially and operationally viable approach for unit-linked funds to gain LTAF exposure. The higher proportion of less liquid assets held by LTAFs (potentially a minimum of 50% under the current FCA proposal) means the 35% cap would be exceeded for a wrapped LTAF, rendering such a structure impossible under the current rules.

4. We therefore welcome the FCA’s proposal to exclude a wrapped LTAF from the 35% cap on illiquid assets where the underlying investor is part of a DC default arrangement, as set out in consultation paper (CP) 20/12. We also welcome the FCA’s expectation that liquidity concentration risks should be considered at the scheme portfolio level rather than at the fund level, which recognises that LTAFs should not be considered a source for short-term liquidity. These changes will allow the LTAF to be appropriately structured within the DC unit-linked insurance environment.

5. Outside the LTAF, we continue to see the 35% cap as one of the main constraints on unit-linked manufacturers’ ability to offer less liquid assets. It also means the LTAF has an advantage over other fund structures, in particular the QIS and directly invested unit-linked funds, because the cap would apply to these structures but not to a conditional permitted LTAF.

6. To ensure consistency in the application of the permitted links rules and more comprehensively remove barriers to productive finance assets, we recommend removing the 35% cap for all permitted links, where the underlying investor is not self-selecting their investments, i.e. permitting the distribution of illiquid assets beyond DC default pension products to other managed portfolios created by the provider. This covers a broader range of long-term savings products that contain pre-packaged investment strategies that are professionally selected and where liquidity risk is carefully considered and managed.

7. At the same time, all supplementary requirements within the permitted links rules, which we believe offer investors important protections, should be maintained (disclosure/communications to customers and suitability assessments).

8. Meanwhile for direct retail where investments are self-selected the 35% limit at the fund level could be maintained to ensure concentration risks are minimised.

9. In addition to these points, we have identified a further barrier in the permitted links rules that would prevent efficient structuring of less liquid assets under current industry life company models, in which life funds invest in other life funds – analogous to the fund-of-fund structures seen in authorised investment funds. Strategies constructed this way work on the basis of being allowed to hold permitted units. However, the definition of permitted units does not cover the illiquid categories of permitted links – including life-wrapped LTAFs – with the result that a life fund could not invest in a life-wrapped LTAF (or any other wrapped illiquid fund). In order to address this barrier to the distribution of less liquid assets in the unit-linked insurance environment, we recommend that the definition of a permitted unit be expanded to cover conditional permitted links.

6.2. RETAIL INVESTMENT

10. While our main focus has been on developing solutions to the barriers to DC schemes’ investment in less liquid assets through workplace pension default arrangements, we also considered the feasibility of making LTAFs available to a wider audience of retail investors. This could increase the range of available products, which might appeal to those investors that do not currently invest in less liquid assets. For example, QIS – another type of open-ended fund – are generally not available for retail investors and are restricted in their use for DC schemes investing via life platforms. And non-UCITS retail schemes (NURS) are able to invest only a small proportion of their assets in unlisted securities. Increasing access to less liquid assets would require overcoming a number of barriers, set out below.

11. In principle, retail investors have two ways of gaining exposure to an LTAF – by investing in it directly or through a fund which in turn invests in an LTAF (such as a NURS or NURS Fund of Alternative Investment Funds (FAIFs)).

12. ‘Retail’ covers a broad range of investors which can include advised mass retail, advised retail, and sophisticated or High Net Worth clients. We are of the strong opinion that direct investments in LTAFs are unlikely to be a suitable product for mass unadvised retail investors. However, the majority of the Group’s members believe that with the correct consumer protections in place, direct LTAF investment could be appropriate for certain types of retail investors. This could have implications for retail platforms’ operations, and for the FCA rules governing the distribution of the LTAF.

13. The rest of this section sets out some of the key considerations which need to be taken account of in endorsing the FCA and other relevant rules, as well as potential solutions to the operational barriers.

6.2.1. TARGET MARKET

14. LTAFs will be able to invest in a wide range of asset classes. As such, their appropriateness for certain types of retail client will depend on their complexity and nature of the underlying investments. Long-term assets of the type that may be held in the LTAF are not necessarily in themselves more risky or inappropriate for well-diversified retail portfolios with long-term investment horizons. However, there may be certain investment strategies or fund terms that will not be suitable for any type of retail client.

15. LTAFs may only be suitable for retail consumers with an investment horizon aligned to the LTAF with one or more of the following characteristics:

- a good knowledge of relevant financial products and transactions;
- relevant financial industry experience;
- accompanied by professional investment advice or included in a discretionary portfolio service.

16. In practice, retail investors could gain access to the LTAF through one of the following distribution channels:

- retail investment platforms;
- financial advisers or planners;
- private wealth managers.

17. For non-advised services, if distribution of the LTAF were considered acceptable those would need appropriate consumer protections in place which should include an assessment of appropriateness, or other form of assurance, of this investment type for this specific investor group. Advised clients would access LTAFs through solutions recommended by their financial adviser or private wealth manager that meet their long-term investment needs.

6.2.2. KEY CONSIDERATIONS

NMPi Rules

18. There are a number of regulations on the financial promotion of investments to different types of retail investors designed to have appropriate consumer protections. For example, in the LTAF consultation paper, the FCA proposed permitting retail distribution of LTAFs only to sophisticated clients as per the current rules for QIS on non-mainstream pooled investments (NMPIs). However, we believe that under this proposal most retail platforms or larger mainstream distributors are unlikely to distribute LTAFs to retail clients. And in their current guise, NMPI rules may also be insufficiently robust to deliver safe distribution of LTAFs.

19. Meeting the NMPI requirements will require material investment in operational and administrative processes alongside high-level appropriateness/suitability assessments prior to promotion. This will significantly reduce the potential role of the LTAF as a means for retail investors to access less-liquid assets. Instead, retail investors may use other vehicles such as investment trusts, Venture Capital Trusts (VCTs) or UK Real Estate Investment Trusts (REITs) to gain exposure to less liquid assets. Discussions with private wealth managers suggest that unauthorised funds such as limited partnerships would be preferred over LTAFs if both are distributed using NMPI rules. Using the NMPI rules as the basis for distribution will, therefore, act as a significant barrier to LTAFs being used by retail investors to gain exposure to less liquid assets.
20. The greater investor protection inherent in the design of the LTAF, compared to some other fund structures (for example, QIS), could provide a basis for retail investment in less liquid assets. With this greater protection in place, it may be possible to refine the NMPI rules to allow retail investors with long time horizons to access less liquid assets through the LTAF. The majority of the Group believes that there are alternative approaches to distribution, which are more commensurate with the proposed levels of governance and investor protection included within the LTAF design.

21. We discussed several options for distributing LTAFs to an appropriate retail investor group, while ensuring adequate consumer protection. This included the use of appropriateness tests, non-readily realisable securities (NRRS) rules and using professional investor status only.

22. Currently, the FCA has a set of regulations derived from MiFID II (PROD) that aims to improve firms’ oversight and governance to ensure appropriate client outcomes for retail products. Overall, building on the existing FCA PROD framework for financial promotion was seen as potentially the most appropriate approach to ensure safe distribution. Combining this well-established approach with enhanced protection, through the use of a limit to the maximum exposure at the retail client’s investment portfolio, is an option that could be considered. Rather than relying on self-certification, there should be a requirement for the distributor to ensure that when LTAFs are purchased, these limits are adhered to either through information already known about the client, or through the provision of evidence of investments/wealth elsewhere.

Tax Rules

23. Retail investor assets are held across Individual Saving Accounts (ISA) and pension tax wrappers, as well as outside of any tax wrapper, and retail investment decisions can be influenced by tax rules.

- Retail investors hold £305bn in Stocks & Shares ISAs. The ISA rules require that funds can be transferred to an alternative ISA manager within 30 days. The restriction to be able to transfer ISAs inside 30 days means they are likely to be incompatible with LTAFs because of the lengthy notice periods necessary to ensure that the liquidity of the fund is aligned with that of its assets (see Section 5.2).

- Within a Self-Invested Personal Pension (SIPP), tax-free death payments could become taxable if they’re not paid within two years. This could also cause potential problems with some of the most illiquid asset classes, with longer notice periods.

- Another legal requirement that affects SIPP is that pension transfers must currently be completed within 6 months. This should not be an issue for investments with infrequent dealing and a long notice period, if they can be transferred to another provider in-specie, i.e. as a transfer of fund units themselves rather than through encashing the holding in order to transfer in cash. But SIPP providers will not know in advance whether the receiving provider will be willing and able to take an in-specie transfer. This may, in turn, preclude some investment in less liquid assets via SIPP.

24. Under current rules, investor monies that are sheltered in ISAs would be unable to be invested in LTAFs, and there may be similar restrictions within SIPPs. However, consideration of tax incentives is not in scope of this Working Group’s objectives, so we have made no recommendations on this point.

Operational Barriers

25. The majority of the Group’s members thought that with the correct consumer protections in place, direct LTAF investment could be appropriate for certain types of retail investors (see Diagram 6.1). That could require changes to platforms to enable non-daily dealing. This is different to the approach discussed in Section 5 for DC schemes that are likely to invest in less liquid assets through a fund of funds.

26. Many platforms already offer non-daily dealing vehicles, which tend to be weekly and monthly dealing. However, this is a shorter timescale than anticipated for certain varieties of LTAF that could be launched. And current processes to accommodate non-daily dealing funds are typically manual, and our initial high-level exploration of these issues indicates little appetite to adopt any automation. However, more work is required on this if non-daily dealing funds, including LTAFs, were to gain scale, platforms would need to consider whether there is a case for automating these processes.

27. Another operational issue for distribution to retail investors is around portfolio rebalancing. Distribution could be more challenging where advisers are recommending model portfolios that are automatically re-balanced. Rebalancing a portfolio of solely daily dealing funds is a functionality that can be used by advisers at present, but a non-daily dealing fund would cause issues to the current rebalancing mechanism. Advisers could allocate outside of any model portfolio, but this additional complexity looks to be a significant hurdle.

RECOMMENDATIONS

We recommend a series of actions to support the distribution of less liquid assets, including through the LTAF, to a broader range of investors including DC schemes and retail investors when appropriate:

- The FCA to consult on removing the 35% cap on investment in illiquid assets for all permitted links, where the underlying investor is not self-selecting their investments.

- The FCA to review the application of the Financial Promotion rules to the LTAF, including the classification of the LTAF as a non-mainstream pooled investment (NMPI), once LTAFs are established. In addition, the FCA to consider further the appropriateness of applying this framework to the LTAF as part of its review of the potential safe distribution to retail investors more broadly. Where the FCA considers that changes to its rules might be appropriate, it should follow its usual public consultation process.

DIAGRAM 6.1: ROUTES FOR RETAIL INVESTMENT IN THE LTAF

Route 1: direct investment

<table>
<thead>
<tr>
<th>Investor</th>
<th>£</th>
<th>Units in fund</th>
<th>LTAF</th>
</tr>
</thead>
</table>

Route 2: investment through a fund of funds

<table>
<thead>
<tr>
<th>Investor</th>
<th>£</th>
<th>Units in fund</th>
<th>Fund A</th>
<th>Fund B</th>
<th>Fund C</th>
<th>LTAF</th>
</tr>
</thead>
</table>

As with default investments, the ability to overcome operational barriers will rely on a sufficiently compelling commercial opportunity.

52. ISA regulations 4(6)(f) and (7) in ISA terms and conditions: Information you need from investors when they apply for an Individual Savings Account (ISA)
54. Pension Schemes Act 93, Part 4ZA, Chapter 1.
Box 6.1. LTAF case study

1. There are several existing fund structures that support investment in long term, less liquid assets, including investment trusts, QIS, and others. However to maximise the opportunity to boost investment in productive finance, there are merits of developing new fund structures. This would broaden the range of investors who could access these types of assets and broaden the range of assets available to invest in. The LTAF is one such structure.

2. Some asset managers are already actively considering how they could use the LTAF fund structure to meet their clients’ needs, once the FCA rules are in place. For example, some of the existing funds help finance sustainable projects, including renewable infrastructure and real estate redevelopment, or help gain diversified exposure to a range of unlisted assets. These types of vehicles could be beneficial for investors looking to diversify their investments, and potentially achieve higher returns. Some investors also appreciate the opportunity to invest in the causes they care about, including the transition to a net zero economy.

3. The LTAF is not just a theoretical concept. Asset managers believe it could be a suitable fund structure to finance similar long-term productive assets that meet the needs of their clients. Some firms among the members of the Group have started planning for the future and actively exploring how they could use the LTAF once the FCA rules are in place. Feedback on client engagement suggests a strong interest from a range of potential investors. The clients note that this fund structure could complement other fund structures. These investors find it attractive to be able to access diversifying, higher return, sustainable investments in a structure where the features such as longer notice periods and less frequent dealing are transparent, and better reflect the underlying investments. An additional comfort to investors is the strong level of governance expected for the LTAF. Asset managers also find the structure attractive as it aligns to client outcomes they are aiming to provide, and where the rules are set keeping in mind the types of investments where both deploying and redeeming capital can take a long time.

Annex 1. Summary of legislation for investments by occupational DC pension schemes

Trustees’ powers and duties to manage and invest the assets of a DC occupational pension scheme arise from general trust law, from the pension scheme’s trust deed and rules and from legislation. The Pensions Regulator has also issued guidance for trustees of defined contribution schemes, including guidance about investment governance. A summary of the legislation that is most relevant to investment in less liquid assets is laid out below.

Trustees generally have the power to invest scheme assets as if they were their own, provided that they must invest in the best interests of scheme members and beneficiaries. When trustees are considering investing in illiquid assets, they must be comfortable that they will meet that requirement as well as other requirements. The focus of the Pensions Regulator when monitoring compliance with investment rules is to ensure that the decision-making process is effective and that the governance process around those decisions is robust rather than a narrow focus on the outcome of such investment decisions.

Pensions Act 1995

Section 34 provides that trustees have the same powers of investment over scheme assets as if they owned the assets themselves, subject only to any restrictions in the scheme rules and to any regulations about choosing investments made under section 36, including s 36(3) which requires trustees to obtain investment advice. The sponsoring employer of the pension scheme has no right to restrict the trustees’ investment powers (section 35(5)).

Section 35 requires trustees with 100 or more members to prepare and maintain a written ‘Statement of Investment Principles’ (‘SIP’) which governs decisions about scheme investments.

The Occupational Pension Schemes (Investment) Regulations 2005

Regulation 2 (Statement of Investment Principles) sets out a number of matters which must be covered in the SIP, including the policies of the trustees in relation to the kinds of investment held, how trustees measure and manage risk, the return they expect on investments and the financially material considerations they put in place, including ESG policies. The SIP must be published on a website.
Annex 2. Other operational considerations for DC schemes

If DC schemes decide that investment in less liquid assets is in their members’ interests and choose to allocate to LTAFs or other non-daily dealing funds, they would need to overcome some other operational barriers – in addition to those around liquidity management in the context of daily dealing set out in Section 5. Our engagement with a range of industry stakeholders suggests that none of these barriers are insurmountable. To accelerate their removal and to help the DC schemes willing to make such investment, this section sets out some of the key considerations and potential solutions to the operational barriers.

Appetite to allocate to less liquid assets over the age of 55

There is, at present, little market appetite to offer less liquid allocations after the age of 55, due to prevailing uncertainty of exactly how people will access their accrued pension savings. Currently, over half of members encash their pensions completely when accessing and these trends could be impacted by factors outside a scheme’s control, such as legislative change, a high profile pension scandal and a change in income tax.

Schemes that wish to allocate to less liquid assets, but not for members over 55, may have to adapt their de-risking approach. Many schemes operate ‘lifestyling’ strategies, which gradually switch members from higher risk to lower risk investments, typically starting with those aged 50-55. To ensure no allocation over 55, schemes may have to alter their approach, either by changing when de-risking starts, the investments that are used, or becoming comfortable with having some, albeit smaller, allocations for those over 55. This could be a significant commercial barrier for firms to navigate.

In the future, people will be more reliant on their DC pension for long-term income and so fully encashing DC pensions should become less prevalent. As such, we expect schemes to become more comfortable with having allocations after the age of 55. We do not propose any solutions to this, rather it will take time for behaviour to evolve.

Communications with members and trustees

An allocation to an LTAF may require additional communication with members. A less liquid allocation, by itself, does not necessitate member communication unless it alters the risk rating of the default fund. However, many schemes choose to communicate such an allocation regardless of any legal requirement to drive member engagement with the investment. It is good practice to include any changes to risk-taking or liquidity risks in any other changes to Terms & Conditions.

Measuring and communicating performance of private assets to members and trustees is challenging for several reasons. Performance measurement requires assurance from valuation teams, highlighting the need for an independent and high quality valuation process, especially given the initially compressed return from private assets (the so-called J-curve). Time lags between benchmarks and actual performance are significant and benchmarking is challenging, so it could be worth focusing on benchmarks at default level (for example, CPI+X or absolute return with inflation assumption added) rather than fund level.

Annex 2. Other operational considerations for DC schemes