By email: pensions.review@hmtreasury.gov.uk

25 September 2024

Dear HM Treasury

RE: Pensions Investment Review: Call for Evidence

The BVCA is the industry body and public policy advocate for the private equity and venture capital (private capital) industry in the UK. With a membership of over 600 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. In 2023, £20.1bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside of London and 90% of the businesses receiving investment are small and medium-sized businesses.

We welcome the opportunity to provide feedback on the Call for Evidence as part of the Government's Pensions Investment Review. Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor ttaylor@bvca.co.uk / Karen Hurst khurst@bvca.co.uk).

Scale and consolidation

1. **What are the potential advantages, and any risks, for UK pension savers and UK economic growth from a more consolidated future DC market consisting of a higher concentration of savers and assets in schemes or providers with scale?**

    - **Private capital drives UK growth**: Private capital scales UK businesses into regional and national champions. It invests in productive UK sectors (e.g. technology) and 50% of UK-managed private capital is invested in businesses across the UK, whilst 90% of investee companies are SMEs. Private capital helps companies grow, increasing jobs, productivity and UK GDP (e.g. venture-backed businesses collectively contribute 60% more GDP per worker than the UK private sector average). Greater DC investment in private capital will boost UK growth and jobs.

    - **Private capital drives higher returns**: The UK's leading private capital industry has a long-term horizon and stronger returns record than public markets. The UK industry's 15% ten-year horizon return contrasts with 5.3% and 7.5% for the FTSE All Share and MSCI Europe, which it has outperformed since 2001. Diversification into private capital also supports higher risk-adjusted returns across investors' portfolios, particularly as innovative, high-growth companies stay private longer. DC investment in private capital will boost the pots of DC savers, who are missing out on growth.

    - **Scale facilitates private capital investment:** Abundant evidence shows scale –done sensibly - helps institutional investors diversify and boosts returns. It reduces costs and increases bargaining power. Crucially, it helps develop the capability to diversify across growth sectors through typically higher performing private capital funds. Scale makes it economical to invest in the expertise required to run private markets programmes effectively.

- **But scale in UK DC remains insufficient:** Overseas pensions invest 16 times more than UK schemes in UK-managed private capital funds. The concentration of most UK DC capital in 36 master trusts is welcome but slow progress. Savers' interests are served by competition between commercial providers, but 36 remains too many given the top 20 master trusts' average AUM is only c.£7bn. Government could use market experience to set a minimum size (alongside diversification targets) for schemes to reach by 2030. Canadian schemes and Nest diversified into private markets at around £30-50bn. Nest is targeting a 30% allocation when it reaches £100bn (around 2030), which is more typical of leading private markets investors globally. Data from CEM suggests pension schemes of around £20bn typically invest 20% in private markets.

- **To achieve effective diversification across the ecosystem, governance and capabilities must also increase:** The principal risk of DC consolidation is that when savings arise from scale, focus remains on the short-term and passing on immediate cost reductions, rather than building capability to diversify and increase savers' risk-adjusted net returns over time, including by investing in smaller, UK-focused private capital funds. Industry has a responsibility as it manages ever more capital to invest in the capability to ensure savers are diversified and access the returns available to overseas peers. Value for Money, whilst driving scale, must also drive greater focus on net returns as the principal measure of meeting this responsibility. Disclosure alone is insufficient, with clear expectations and more direct intervention from the regulator required. Government should signal the need for change to happen at pace as scale grows, rather than once achieved.

2. **What should the role of Single Employer Trusts be in a more consolidated future DC market?**

    - No response.

3. **What should the relative role of master trusts and GPPs be in the future pensions landscape? How do the roles and responsibilities of trustees and IGCs compare? Which players in a market with more scale are more likely to adopt new investment strategies that include exposure to UK productive assets? Are master trusts (with a fiduciary duty to their members) or GPPs more likely to pursue diversified portfolios and deliver both higher investment in UK productive finance assets and better saver outcomes?**

    - Pragmatically, the Government should focus on the master trust market's exposure to UK productive assets because, within the pensions system, master trusts are the segment most likely to experience organic Assets Under Management (AUM) growth in the coming years. DWP analysis estimates that the trust-based market is likely to grow from around £130bn AUM in 2023 to about £420bn in 2030 in real terms. Much of this growth will come from the largest master trusts, with the five largest potentially holding around £300bn in assets by the end of the decade. Combined with further consolidation at pace and an effective re-orientation towards investing in capacity and focussing on net returns (including through the VfM framework), this organic growth likely makes the master trust market the most fruitful area for focus. This is also why the BVCA-convened Pensions and Private Capital Expert Panel (see answer to Q4) focussed on facilitating master trust investment in private capital.

- Based on engagement with the pensions industry, we believe that trust-based schemes are more likely to invest in a broader range of assets. The fiduciary duty of DC trustees has an important role in ensuring savers' pots are invested in productive assets. This duty incentivises pension trustees to make a holistic assessment of investment propositions, and they should be receptive to the compelling argument that beneficiaries' best interests are served by schemes building diversified investment portfolios that include allocations to private capital funds.

- We note that the UK and overseas pensions schemes that invest successfully in private capital funds are often structured as trusts.

4. **What are the barriers to commercial or regulation-driven consolidation in the DC market, including competitive and legal factors?**

    - The Pensions and Private Capital Expert Panel (the "Expert Panel") is an industry-led group of senior DC and private capital leaders, established by the BVCA with the ABI and PLSA, and supported by around 50 technical experts from across the DC and private capital industries. Its Interim Report in September made a range of recommendations to industry and policymakers for facilitating greater DC investment in UK growth companies.

    - The UK DC master trust market is the area where scale is most likely to be achieved soonest, through organic growth and commercial (and regulation) driven consolidation. The Panel focussed on solutions, having identified the relevant barriers for this section of the market in February 2024.

    - The following Expert Panel recommendations aim to ensure that DC master trusts are empowered to invest in productive assets as scale is built (rather than once it has been built), and to smooth the path towards scale:

        - **Recommendation #1:** "The pensions industry should be empowered to move away from short-term cost considerations, towards long-term returns." This objective should be prioritised within the 'Value for Money' framework so that it is achieved in parallel to scale and consolidation.

        - **Recommendation #2:** "Consistent cost disclosure requirements should be applied across the investment ecosystem." Existing cost disclosure requirements and frameworks must be consistent and useful and regulators should promote consistency throughout the investment chain when developing or revising reporting rules. This will improve the flow of information and capital, and facilitate smoother growth and consolidation in the market.

- **Recommendation #6:** "The Government should consider overseas learnings… tailored to the UK market… when designing new UK vehicles or schemes to facilitate pensions investment in high growth companies." This links to the answer on UK investment below.

- **Recommendation #8:** "The FCA should… amend the permitted links rules to enable life insurance platforms to offer more private capital opportunities to DC schemes." This will ensure that the larger schemes investing through insurance platforms can deploy capital into established types of investment fund more commonly used for private capital investment by other investors.

- **Recommendation #10:** "Regulators should work with industry to provide reassurance and updated guidance on liquidity expectations around stress events." The volume of deposits in large master trusts means day-to-day liquidity is less of a concern. However, concerns about managing liquidity in relation to material one off events (such as market consolidation), may deter schemes from increasing private capital exposures. Additional guidance from regulators could help address this and make consolidation easier to achieve.

5. **To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?**

- **Some success but further reform is needed**: Pooling has had some success in promoting LGPS investment in UK productive assets. The LGPS has around 15% allocation to private markets and 6% in 'private equity'. However, the UK scheme as a whole has a combined value of over £400bn, putting it amongst the largest pools of capital in the world. Asset owners of that size often have around 20-30% invested in private markets. This discrepancy arises in part because the pooling project is incomplete - it covers less than 50% of assets, remains fragmented across eight pools and 86 funds, has not always been structured in way that facilitates private capital investment and does not extend to Scotland. Therefore there is more to be done.

- **LGPS reform has foundations to build on:** The LGPS has in-built advantages for private capital investment because as an open public DB scheme it does not face the same challenges for investing in private capital as the commercial DC market has historically. As noted above the LGPS already has relevant expertise and experience, albeit varying between pools and funds, and an interest in supporting regional and UK investment.

- **More pooling:** Similar to DC, scale is important for diversifying into private markets and improving performance. The Government should accelerate the transfer of control of assets to pools and potentially consolidate the pools where they are not delivering greater diversification, improving performance and (potentially) increasing UK investment. Pools also offer cost-effective expertise that should remove the need for partner funds overly to rely on external consultants (not all of whom have relevant expertise at local UK levels).

- **Better pooling**: BVCA members' experience suggests that pools with an FCA-regulated asset manager are better able to execute effective private markets programmes. This enables the creation of a centre of investment expertise for partner funds to gain access to range of local, regional and global private capital opportunities. That relationship experience and local expertise can often be very important in accessing UK investment opportunities. Border to Coast, for example, from a pool of £45bn, has £10bn invested in the UK and partner fund commitments of £16bn to its private markets programme. The pools with a regional focus and the relationships needed for partner funds can lead to success accessing strong UK investment opportunities.

- **Better governance**: As with DC, the advantages of scale from pooling should not merely aim to cut costs; rather it should focus on building the necessary capability and governance needed for diversification and stronger performance (including by investing in smaller private capital funds with strong track records in more UK-centric investment).

Costs versus Value

1. **What are the respective roles and relative influence of employers, advisers, trustees/IGCs and pension providers in setting costs in the workplace DC market, and the impact of intense price competition on asset allocation?**

    - Both providers and consultants/advisers appear to have substantial influence in focusing the market on lower cost products for commercial and, to an extent, regulatory reasons. Employers are arguably in a strong position to influence a shift from cost to value but we have not seen evidence that their role has shifted since the OFT DC market study in 2013. The charge cap seems to have succeeded in pushing costs down, but not in driving competition.

    - The Value for Money framework is very welcome, but overall seems unlikely to drive a significant shift in employer (or saver) behaviour in the medium term. This point was noted in discussions of the Expert Panel, where there was scepticism around likelihood of achieving significant cultural shift towards greater engagement from savers or employers. In this context, we note that the existing VfM framework for small schemes seems to have had little impact in driving smaller schemes to focus on better value (flagged by the Pensions Regulator in a recent survey that found "only around one-quarter (24%) of DC schemes met TPR's key governance requirement to assess the extent to which member-borne charges and transaction costs provide good value, with larger schemes, such as master trusts, more likely to meet it".

    - We are seeing a change in attitude towards competition/price, as evidenced by the 2023 Mansion House Compact and other market developments. However, we remain concerned that progress may be slow and that addressing operational barriers often take priority. If the Value for Money framework takes a decade to embed, a young saver who was auto-enrolled in 2012, in a default strategy, is overwhelmingly likely to retire without an adequate income (we note the PLSA's work with Loughborough University on Retirement Living Standards in this context).

- This makes it essential for the Government to build on the Value for Money framework by ensuring that there are clear expectations and plans for regulators to intervene where schemes are underperforming. Here there may be helpful lessons from e.g. Australia where the relationship between pensions/employer has ensured sensible focus on value rather than drive to low cost. The Government should also ensure that any industry benchmarking does not focus on cost but is instead against a framework focused on value for money in terms of net of fees investment performance, active stewardship, and broader contributions.

- Alongside setting of expectations and further powers to intervene, the Government also has a role in supporting market participants to convene, share best practice and develop tools to help schemes meet those expectations. One industry-led example of this is the proposal from the Expert Panel for the development of a template DC Request for Proposal for private capital investment, as a tool to facilitate the flow of information and capital. Other examples identified by the Expert Panel included dedicated training for trustees, based around the "private capital explained" material in the Expert Panel's Report, and the potential use of an accreditation system, as features in the French Tibi scheme.

2. **Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?**

   - Yes. It is important that UK pension providers do not just bank or pass on cost savings from scale in order to offer products as cheaply as possible, whilst benefitting from increasing fee income generated from growth in AUM as savers' pots grow and schemes consolidate. Instead, the benefits of scale should lead to investment in the capability required to execute portfolio strategies that will improve savers' overall risk-adjusted net returns. Scale should be seen as platform for diversification. Government has an important role to play (as covered above), for example by setting clear expectations and plans for regulators to intervene where schemes are underperforming. We would be happy to engage in further conversations around this topic or any others in this section.

Investing in the UK

1. **What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?**

- **Scale will lead to more UK investment and growth:** Scale accompanied by stronger governance and greater focus on net returns will give UK pensions the resources and incentives to execute more sophisticated allocation strategies and diversify into private capital. As pension schemes diversify into private capital, seeking stronger net returns, they are highly likely to partner with firms from the world-leading private capital eco-system on their doorstep (the UK has the second largest private capital market in the world). Funds managed by firms within that ecosystem invest disproportionately large amounts into the growth of UK companies (50% of their total capital goes into UK businesses).

- **Both large and small private capital funds play an important role in diversification and UK growth:** Larger funds facilitate deploying large amounts of capital targeting strong net returns from growing large companies across geographies, including the UK. Smaller private capital funds (£100m-£500m) also offer strong net returns and a critical role in scaling small, innovative UK companies into successful national and international businesses. These companies often need £10m-£50m investments to fuel the crucial next stage of growth - amounts typically only available from smaller venture and growth equity funds, which form a vital part of the ecosystem for building UK companies. Smaller funds often offer more concentrated exposure to particular sectors and geographies (e.g. UK), boosting returns. They can help pensions achieve specific diversification, regional impact or sustainability objectives whilst deploying capital to drive growth.

- **It is important that UK pensions can invest across the private capital ecosystem:** Pensions and other investors typically seek to avoid their capital constituting more than 10-15% of a private capital fund, to ensure appropriate pooling of risk with other investors. This means the maximum amount a UK pension can deploy to one smaller private capital fund is typically around £50m, which presents challenges as an investor grows. To make investments of that size economical, UK pensions need dedicated teams, structures and governance to manage multiple smaller commitments (£50m and under) separately to their larger allocations to e.g. global private equity. To ensure that UK pensions can continue allocating to all parts of the ecosystem as they scale, building on the work of the Expert Panel, we suggest Government:

    1. Sets clear guidance and expectations for pensions, including within the VfM framework, around diversification and how to build teams that invest from dedicated pools into smaller private capital funds and UK assets (drawing on the success of Border to Coast and others). This should fall short of prescriptive requirements to allocate because of the risk of market distortions and fiduciary duty considerations.

    2. Introduces a Government-supported investment scheme/vehicle building on BBB UK investment expertise (and learning (e.g. accreditation) from overseas initiatives such as the French Tibi scheme), or a similar private sector fund of funds, to pool UK pension capital in a cost-effective manner that achieves diversification through to smaller UK-

focussed funds whilst increasing the supply of capital to high-growth UK companies. For more detail see the Expert Panel's Report.

2. **What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?**

   No response.

3. **Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?**

   - Mandatory requirements to invest in asset classes or geographies are likely to create an inherent tension with DC and LGPS fiduciary duty and would risk infringing on schemes' ability to optimise returns for the scheme and its members. They also risk causing market distortions if capital is forced into parts of the market that may have insufficient high quality supply of assets, leading to price bubbles, negative impacts on returns and diversion of capital away from other investments that may be more productive.

   - As described above, the best way to ensure UK investment increases is for Government to set clear guidance and expectations for pensions, including within the Value for Money framework, around diversification and how to build teams that can invest from dedicated pools in smaller private capital funds and UK assets (using the experiences of Border to Coast and others who have successfully allocated in this way as they have grown). This should fall short of prescriptive requirements to allocate because of the risk of distorting the market and tensions with fiduciary duty.