BlackRock

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HM Treasury
1 Horse Guards Rd
London
SW1A 2HQ

Submitted via email to: pensions.review@hmtreasury.gov.uk

RE: Pensions Investment Review: Call for Evidence

BlackRock[1] is pleased to have the opportunity to respond to the HM Treasury (the "**HMT**") Pensions Investment Review call for evidence.

BlackRock manages the pension savings of over 12 million people in the UK and our investment approach is rooted in our fiduciary duty: we start with our client's objectives, we seek the best risk adjusted returns, and we underpin our work with research, data, and analytics.

We are incredibly proud of our work to manage the pension savings of people across the UK, indeed, BlackRock and our predecessor firms have been serving UK pension schemes for over fifty years. We are one of the largest managers of UK DC assets, including those saving through NEST, workplace schemes, and Master Trusts. We similarly work very closely with the LGPS segment, managing assets for 62 LGPS and eight LGPS Pools.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of HMT on this and other topics.

Yours faithfully,

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[1] BlackRock is a leading provider of investment, advisory and risk management solutions, and has been active in the UK for over 50 years. Our purpose is to help more and more people experience financial well-being.

Scale and consolidation

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?

From the outset, it is worth noting the considerable consolidation that has been taking place in DC in recent years. The average size of DC schemes is already increasing as the market matures, due to both automatic enrolment and market forces that allow schemes and employers to choose consolidation where in the best interest of members.

Whilst there are still thousands of very small schemes, most assets are managed by Group Personal Pensions and authorised Master Trusts. Master Trusts account for 90% of DC trust-based memberships (the majority of the market), with 82% of members concentrated in the largest five Master Trusts by assets under management.[2] In its November 2023 paper, DWP and TPR forecast that this will continue to concentrate, particularly amongst larger schemes. [3]

Overall, this has been positive for the industry, as there are clear benefits linked to consolidation, most notably: economies of scale, reduction in member charges, as well as greater investment opportunities and expertise. As one of the largest managers of DC assets in the UK, we have observed a marked professionalisation of the DC segment in recent years and see this as an overwhelmingly positive trend for member outcomes.

In terms of risks, we would highlight that as the market becomes more consolidated into large commercial entities and with the introduction of the Value for Money (VfM) framework, there is the risk of the type of 'herding' we see in the Australian market. With less competition, the remaining providers may not want to be an outlier from a performance/outcome perspective, which may be at odds with the type of investment in private market assets, which the Government is trying to encourage[4]. Whilst it is welcome that the FCA has said it will not introduce regulator defined benchmarks for VfM, this risk of herding in a more consolidated market persists.

Hence, while we recognise the importance of comparability, it is important to encourage some diversity within the market. There is a need for schemes to be able to explain what they are trying to achieve and why they are making the investment decisions they are. This text should be included as part of the template for the final agreed metrics, making space for schemes to lay out their objectives and explain why they are in the interest of their members.

We would also note that, as the market becomes more concentrated, and especially as DC schemes look to invest in private market assets, there is a risk of these large schemes all chasing the same assets and ultimately driving up costs.

Our position on requirements around asset allocation is covered in detail in the final question, but this risk of creating asset price bubbles, if a large number of investors are seeking to invest in a relatively small pool of UK assets, is one of the reasons we are opposed to hard mandates for UK investment. As we do not believe this type of price inflation would represent a good member outcome.

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[2] Over 10m people currently save into a DC trust-based workplace pension compared to around 5.6m in DC contract-based, DC trust: scheme return data 2022 to 2023, January 2023
[3] Evolving the regulatory approach to Master Trusts, November 2023
[4] BlackRock response Value for Money: A framework on metrics, standards, and disclosures, April 2023

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

Whilst we would stress that there are many benefits to consolidation, scale is not the sole determinant of scheme quality and there are many well-run Single Employer Trusts, who deliver excellent value for their members. We would see it as a risk to positive member outcomes if there was a drive toward consolidation, which did not allow for the continuation of Single Employer Trusts who are delivering innovative investment solutions and value for their members.

- It is worth noting again that consolidation is already taking place and there are likely to be far fewer Single Employer Trust schemes in future. As the regulatory burden continues to increase, including on VfM reporting, climate reporting, TCFD, governance requirements etc, more Single Employer Trusts will choose to consolidate into a multi-employer scheme.

- However, there are those who will not choose to consolidate and, in our experience in the DC market, we see schemes who have not chosen consolidation as they want to do something different and innovative for their employees. Indeed, Master Trusts deliver great outcomes for the average saver, but they are not specific to the underlying scheme demographics. Single Employer Trusts meanwhile can tailor the investment experience to their specific demographic.

- The most obvious example of this type of innovation is the work that Royal Mail has done to set up its CDC scheme, but there are many other Single Employer Trusts innovating for their members. Whilst we expect to see CDC expansion into Master Trusts, it is not surprising that the first mover would be a Single Employer Trust where the employer holds significant demographic data on its employee base and so is able to develop a bespoke solution which is reflective of its membership.

Of course, we are very supportive of the work that has been done on the VfM framework and believe that any Single Employer Trusts that are not delivering value to members should move toward consolidation.

We will be responding to the FCA consultation on VfM separately, but one potential anomaly in outcomes we would highlight in relation to this question is the role of the proposed "penalties" of the framework. Where schemes fail to demonstrate value they will be prevented from taking on any new employers - this will provide no deterrent to Single Employer Trusts who are not seeking business with any further employer[5]. It would only be after four years of not providing value that these schemes would be required to transfer their members.

Given the stated aim of forcing those schemes delivering poor VfM to consolidate into better performing schemes, there may be a need to reconsider how this penalty works in a Single Employer Trust context.

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

[5] https://www.fca.org.uk/publication/consultation/cp24-16.pdf

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?

Both Master Trusts and GPPs have a major role in the future pensions landscape. There are significant ongoing inflows into both. While consolidation is happening at pace in the Master Trust market, it has already occurred in the GPP market, with a small number of players already at scale.

In terms of differences between the regimes, Master Trusts and GPPs differ in their legal basis and their regulation. DWP, FCA and TPR have deliberately worked together and could go further to align the regimes – not least by simultaneous implementation of fundamentally similar VfM rules. Other measures in the Consumer Duty and arising from the Advice Guidance Boundary Review could also apply to occupational schemes, to align service standards.

We would also note that insurers face certain regulatory barriers around permitted links and recommend exempting qualifying workplace DC schemes from the FCA's permitted links rules, to enable sophisticated investment implementation across the DC market.

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

In its November 2023 paper on Master Trusts, DWP and TPR stressed that alongside reducing the number of small schemes, they would welcome consolidation at the large end of the scale where it is in the members' interests, as seen in Australia, where seven of the eight largest 'My Super' entities have around £30bn in assets under management.[6] We would note that whilst there has been considerable consolidation in the market, we have seen consolidation happen less quickly at the Master Trust level.

There are a number of drivers for this, most notably, whereas an employer can take the decision to consolidate into a Master Trust with relative ease, the process of merging Master Trusts into one another is more complex. For example, Master Trust A may have negotiated lower fees with employers, if these fees are lower than Master Trust B there is no process to renegotiate these fees when consolidating A & B.

Past investment performance is also a potential barrier as the VfM framework comes online – as well-performing schemes may not want to acquire a poor past performance record. It is welcome that the FCA's consultation recognises this as a potential barrier and seeks to avoid it.

Furthermore, from an operational standpoint, it is worth highlighting that, throughout the DC market, data collection is not uniform. As a general suggestion for market improvement as part of this review, we would suggest that moving toward more uniform data collection would improve efficiency across industry and make consolidation simpler.

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?

[6] Evolving the regulatory approach to Master Trusts

Scale can deliver significant benefits. It tends to be linked to more resources dedicated to governance, stronger negotiation power over fees, and greater investment expertise. In this respect, we believe that pooling has been a success story, there are considerable examples of where pooling of assets has enhanced purchasing power, strengthened investment decisions, and benefitted member outcomes. However, whilst pooling has certainly led to strengthened investment decisions in some cases, we would stress that there is not always a direct correlation between scale and quality.

Governance and investment oversight are key drivers of delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes. Insofar as scale allows further resource to be dedicated to these functions, we believe that members will see improved outcomes only if the governance and oversight functions are equally invested in with a focus on setting and reviewing appropriate investment objectives supported by a comprehensive risk management framework.

For example, the "governance premium" is estimated to be around 0.6% per annum additional return (and has been estimated as high as 1-2% p.a.); this relates primarily to clear delegation of investment decision-making with strong oversight and scrutiny by the asset owner board[7].

Given the scale of the assets LGPS pools are expected to manage in coming years, it would follow that this is reflected in the resource dedicated to investment oversight, operations, and governance. Hence, we believe there is a need to balance any drive toward further pooling, with ensuring effective governance, investments and risk structures are put in place.

In line with this, we support the continued development of the LGPS pool model, which focuses on these issues and learns lessons from what is working well currently. We welcome MHCLG's commitment to providing its guidance on this and the roles and responsibilities of Funds and Pools.

Costs vs Value

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?

An intense focus on price has led to competition to reduce costs rather than focus on long-term value, and we see this is one of the key barriers stopping pension providers from investing in a wider class of assets. Indeed, Master Trusts have been vocal about the focus on costs limiting their ability to develop their investment proposition into private markets[8].

It is important to recognise that schemes are typically charging below the charge cap for a variety of reasons. In theory this headroom could be utilised to invest in illiquid or other alternative assets which typically carry a higher management fee.

All parties have had some role and influence in costs being as they are, where a 'cost is king' culture has emerged and we have suggested some remedies to help tackle this issue in the following question.

[7] Pensions Policy Institute, Briefing Note: Defined Benefit – the role of governance
[8] DC Investment Forum, Growing Pains: Master trusts beyond auto-enrolment

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?

As stressed throughout this response, we are very supportive of the VfM framework, which we see as a crucial way to drive further focus on value over cost. Indeed, this focus on value over costs is something we have consistently championed in other regulatory responses, so this is a very welcome development.

Whilst, again, we will be responding the FCA consultation separately, there is one issue which we believe is important in relation to this question. Given the role of Employee Benefit Consultants (EBCs) in helping employers to choose a suitable pension scheme for their employees, for the VfM framework to be successful there is a need to ensure consultants take it into account when advising employers through some form of duty or industry commitment.

We would also note that alongside this, there is a need for further guidance for employers. The current TPR guidance only refers to costs and how they are structured, the type of tax relief used by the scheme, additional services offered by the Master Trust or provider, such as writing to members, and whether it fits with the payroll systems they use. This does not give sufficient support to employers who are unfamiliar with the pension landscape and will not drive the outcomes the Government is looking to see in this segment.

One other issue we would highlight is the daily dealing eco-system, which is a barrier to private markets access and ultimately higher investment returns. Whilst regular subscription points are useful to reflect differences in payroll dates from underlying employers, the Long Term Asset Fund (LTAF) may only allow redemptions on a monthly or quarterly basis. Hence, we see the Review as an opportunity to set a clearer set of policy and regulatory expectations with respect to the UK fund distribution infrastructure to enable wider use of the LTAF and, as appropriate, other vehicles.

Investing in the UK

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?

In recent years we have seen increased interest in investment in private assets from both the DC and LGPS segments, however, it is worth noting that they are in different positions in relation to the allocations they can and have been able to make.

There has been, and continues to be, great enthusiasm from LGPS to invest in private assets of all descriptions – private credit, private equity, infrastructure and real estate – based on greater understanding and insight on the positive impact these allocations can have on their investment portfolio.

Some of this comes down to scale gained through pooling as highlighted in the question, however, as stressed earlier in this response – governance and investment oversight are also key to making this investment successful. For example, a smaller Fund may invest into a multi-alts fund for their private market allocation, whereas when

assets are pooled they are able to invest directly into underlying asset classes/co-invest deals, allowing the Pool to be more targeted in allocations, and focus into specific themes – such as UK growth.

DC is at an earlier stage of private market investment, with recent welcome regulatory changes - such as the creation of the LTAF and carving out of performance fees from the charges cap – removing some of the barriers to this type of investment. Some other barriers, including the daily dealing eco-system, have been highlighted in this response.

Given we are already seeing increased interest in making private market allocations and assuming continued consolidation amongst DC schemes and a shift to assessment of long-term value rather than cost alone, we are likely to see further DC investment in private assets. In terms of incentivising this investment into the UK, this is covered in response to the final question.

In regards to listed equity, it is worth noting that there has been a shift towards diversifying by building portfolios with a global market-weighted approach to equities, where investment is allocated broadly in line with a market's weighting in global indices. This has been positive for industry in terms of returns and is a trend we see globally. Given this context, it may be sensible to consider whether standalone allocations may need to move away from large cap and focus on small and mid-cap equities.

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?

Whilst we will cover some of the factors which need to be tackled in order to make the UK more attractive to pension investment in the next question, we would highlight a number of more general factors which have led to a decline in pension allocation to UK equities.

- Following changes in accounting standards which required a company to state any shortfall in its DB scheme as a financial liability, DB pension schemes moved to hedge their interest rate liability, their inflation, and their longevity to avoid swings in reported shortfalls. In line with global trends, there was also a decrease in appetite among employers to fund them and so the majority began to close. Consequently, their members require, or will require, predictable incomes in retirement. This combination led to a move away from growth assets (equities) to UK Fixed income assets, making the relative cost of capital for UK companies more expensive.
- The equity allocation in the portfolios decreased, and within that the allocation to UK equities decreased. In terms of DC schemes, there was a shift to more diversified approaches across asset classes, gradually over time and particularly following the 2008 financial crisis. Prior to 2008, the asset allocation in accumulation was 'largely, if not wholly invested in equities' before switching to long-dated gilts (to target annuity purchase) and cash as members approached retirement[9].

DB is not covered in this call for evidence, however, we would note that the rise in interest rates which has led many schemes to go from a deficit to a surplus may help

[9] DC Investment Forum, Growing Pains: Master trusts beyond auto-enrolment

to change this picture slightly and we await DWP's response to the Options for DB consultation with interest.

There are two factors at play here, firstly – the ability of schemes to invest in riskier assets using surplus – whilst this will not reverse the decline in investment in UK equities by DB schemes, with a surplus of £475bn this is a significant pool of possible investment.[10] Secondly, with schemes now in surplus, companies will be able to use capital which in the past they had used to top up schemes for investment back into the company. Indeed, there are examples of employers who have used the current surplus in their DB scheme to cover DC contributions, freeing up that capital for further productive investment.

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?

When thinking about investment in the UK, it is essential that any calls for further investment are balanced against the need for pension schemes to make investment decisions based on the interests of their members. Pensions are first and foremost vehicles for people to save for the future and we would not support a hard regulatory requirement on pension schemes to increase their portfolio allocations to UK assets, but rather support discussions on boosting the attractiveness of the UK as a destination for investment.

Whilst it is not the role of pensions to boost UK competitiveness, it is important to note that economic growth is not only important as a marker of the financial health of a country, but also to the financial wellbeing of its people, including those saving for retirement. It is in the interest of savers to live in a thriving economy.

Hence, we continue to be supportive of the work this Government is doing to attract investment and boost UK growth. Indeed, this is a conversation we are actively involved in through a number of forums, including the British Infrastructure Council.

In line with this, we have been pleased to see the commitment Labour has made to tackle some of the most difficult issues which are often held up by our investment teams as creating barriers to further investment – most notably planning and grid restrictions.[11]

Complex problems rarely have simple solutions. Ultimately, forcing pension investment would not solve the root causes of the problem and does not boost the attractiveness of UK as a destination for overseas investment. To do that requires a more holistic conversation about the interventions which will meaningfully help stimulate robust economic growth and improve the financial wellbeing of people across the UK.

Measures to attract further pension investment

Thinking about some of the policy interventions we have seen over the last year - whether that be the voluntary Mansion House Compact, or the ambition for LGPS to invest 10% in private equity and 5% in levelling up – the industry stands ready to

[10] The PPF 7800 index, September 2024
[11] BlackRock response: Update to Green Finance Strategy – Call for Evidence

further invest in the UK and we as an asset manager stand ready to help our clients with this.

Demand is there and investment in UK growth is compatible with the continuation of investment freedom and fiduciary duty. However, for trustees and managers to allocate funds to any asset, they need to offer attractive risk-adjusted returns net of fees – this is what will enable their members to retire securely.

We are very supportive and were involved with the work the PLSA has just done in this area and in terms of policy interventions, support their suggestions[12]. We also have a number of our own, sourced from conversations with our investment teams on the issue.

- *Policy certainty and a stable macro environment:* The Government has control or influence over many of the most important variables that influence decision making of not just investors, but the enterprises that will seek their financing. The available labour supply and its mix of skills, industrial strategy, tax policy, planning policy and the fiscal, monetary, and regulatory environment all influence the viability of new enterprises or projects. Policies for these areas need to be pragmatic and calibrated to engender a supportive business environment. But whilst the substance of policy in these areas is critical, stability and predictability are equally if not more important: uncertainty about government's commitment to specific policies over an extended period creates risks that businesses and investors cannot price, dampening activity. Long-term, durable commitments to policies that support and enable investment are necessary. Setting out and implementing a clear plan for the future of the UK economy, for example regarding an industrial strategy, will aid the return of confidence to UK markets. Policies are needed which allow industry to develop solutions for the long term; a good example of this is the LTAF.

- *Supporting UK growth sectors:* The UK has strong advantages in a number of sectors, including financial services, pharmaceuticals and life sciences, technology, and the creative industries. Policy can promote the expansion of these sectors by focusing on the barriers preventing them from seeking finance to expand their operations, improving their international competitiveness. For example, in the pharmaceutical and life sciences sector, ability to develop laboratory space is often cited as a constraint. Despite the UK's leadership in the sector, timelines to receive planning approval for development of new facilities are longer than in other countries, creating a competitive disadvantage. In Ireland, for example, healthcare infrastructure – which can include laboratory space – is classed as a Strategic Infrastructure Development, where planning proposals are submitted to a central government planning authority, allowing planning decisions to be expedited.

- *Fiscal incentives:* One way the Government might look to make investment in the UK more attractive is through the tax system for pension schemes. Australia is often held up as a model for the UK pension system, both for its allocation to private markets and its bias for domestic investments, however we would note that Australia incentivises domestic investment through the tax system. Whilst Australia's system is unique to Australia, we would suggest the UK look at fiscal incentives, e.g. tax or other treatment. The LIFTS initiative is a good example of an incentive that should work well as it alters the risk-reward calculus, including

[12] Pensions and Growth: Creating a Pipeline of Investable UK Opportunities, PLSA

through pari passu co-investment and fee offset structures. However, greater scale will be needed to drive progress.

- *Focus on infrastructure:* In the UK, policymakers have identified a particular need to increase development of energy infrastructure, to meet both the demands of the transition to a low-carbon economy and to enhance the country's energy security. Successive governments have set ambitious targets for energy generation capacity across a range of sources. Private sector investment has already played a significant role in financing the UK's infrastructure base, but meeting the ambitious targets set by the government will require further focus on getting the policy environment right to continue to attract private capital. There are several crucial factors private investors have to take into account when considering an infrastructure project: whether the design and technology underpinning the infrastructure is proven, in development, or early-stage; whether the business model of a given project or enterprise is proven; and the attractiveness of its risk-return profile – which is influenced significantly by government policy, regulation, and support mechanisms. We would also note the importance of project procurement bodies understanding the investment needs of institutional investors such as pensions and accommodating their needs into investments design.

- *Blended finance:* The Government is looking to the pensions industry in particular to help meet its funding needs across a range of sectors. Clarity on how the Government intends to approach blended finance, including on the structure of blended finance funds and their governance, would be helpful. The National Wealth Fund (NWF) could represent a pool of capital for schemes to partner with. If the NWF can de-risk new asset classes with its catalytic capital, schemes could potentially provide the next wave of capital into those projects, working with existing specialist managers to direct and manage that capital effectively. However, clarity is needed on how this might work in practice.

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