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BVCA briefing: Private capital and UK pension funds

The BVCA welcomes the clear commitment from the UK Government to achieving increased investment from UK pension funds into private capital. The Pensions Investment Review and associated Pension Bill are encouraging steps in the right direction, and the BVCA is formally responding on the specific points in the Pensions Review call for evidence.

The purpose of this paper is to set out more fully the challenges that need to be overcome to achieving the aims of boosting investment and delivering higher returns for savers, and proposes solutions across the pensions and investment landscape.

This paper is informed by work on the Investment Compact for Venture Capital & Growth Equity (the "Compact"), a commitment by over 100 UK venture capital and growth equity fund managers to develop a long-term and constructive working relationship with UK pension investors. Together with the pensions industry, the BVCA convened the Pensions & Private Capital Expert Panel to find solutions to technical, market and policy challenges that currently limit pension scheme investment into private capital funds. The Expert Panel published its Interim Report in September 2024, available here.

This paper builds on this valuable collaboration with the pensions industry, and the BVCA and its members will continue to work with them. However, as the BVCA we are very clear that increasing investment from UK pension funds into UK private capital is vital to both driving economic growth and improving the retirement prospects of UK savers.

This paper sets out the BVCA's view on what needs to be in place to achieve this. It also proposes solutions to some of the potential barriers to moving forward. Achieving the Government's ambition will require concentrated effort on all sides – from government, the pensions industry, the private capital industry, and regulatory bodies.

Introduction

The Government has an important role in setting out expectations on both the pension and private capital sectors, alongside setting a timeframe to resolve some of the policy and regulatory challenges that stand in the way of more pensions investment into productive UK assets including private capital funds such as private equity and venture capital which back fast-growing UK businesses.

Private capital investments generate good returns for investors. As of December 2023, UK private capital funds delivered a 10-year horizon return of 15% compared to 5.3% for the FTSE All Share and 7.5% for the MSCI Europe index over the same period.

Over recent decades, the evolution of the UK pensions industry – the move away from DB to DC funds, and the continued evolution into larger Master Trusts - has made it harder for pension savers to benefit from the returns, and diversifications, typically offered by private capital.

Sixteen times more capital from pensions around the world goes into UK private capital than UK capital. UK pension funds are investing less in private markets than comparable asset managers.

The Canadian pension schemes most active in private capital investment typically allocate on average 21% of their capital to private equity, and major US schemes average around 14%. Large asset owners typically have 20-30% invested in private markets. In contrast, the Local Government Pension Scheme (LGPS) currently has 6% invested in private equity[1], and signatories to the Compact hold 0.36% of their funds in "unlisted equities"[2].

This means that UK pension savers are currently missing out on the returns generated by private capital in the UK, which pension savers in other countries currently benefit from.

The reasons for this are complex, though the move from pooled risk models to individual 'pots', and a dependence on savers making complex investment decisions, are clearly a significant factor.

It also means that UK businesses miss out on investment. UK-based private capital investors tend towards a home bias, investing around half of the capital they manage in the UK without any regulatory requirement to do so.

The UK is lagging behind in comparison to its international counterparts. Over 85% of capital raised by PE & VC funds in 2023 was from overseas LPs (£51bn out of £59bn). This rises to 97% when looking at fundraising from pension schemes (£16.2bn out of £16.7bn). Put another way, only 3% of the total pension funding committed to UK managed funds in 2023 came from UK pension funds[3], despite the industry's long track record of producing strong returns for investors.

The UK has made several attempts to address this long-standing issue through industry-led initiatives, including in 2020 through the Productive Finance Working Group, and latterly, via the Pensions and Private Capital Expert Panel in improving the conditions for DC pension savers to better access private capital investments.

We are now seeing interest in private capital from increasing numbers of pension schemes, and private capital firms engaging on the matter: 11 of the largest pension providers signalled their ambition to allocate £50bn of their default capital to unlisted equities by 2030, and over 100 private capital firms signed the Compact[4].

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[1] Local Government Pension Scheme Advisory Board
[2] ABI Mansion House Compact: Year One Progress Update
[3] BVCA: Private capital: Building a better economy for the future report 2024
[4] The BVCA Investment Compact

However, action from Government, regulators and industry, whilst positive has thus far not met the scale of the challenge. As referenced above, signatories to the Mansion House Compact currently hold the equivalent of 0.36% of the total value of their DC default funds in unlisted equity assets (£793m of £219bn).

The ambition of the Compact is to allocate at least 5% in "unlisted equities" (which covers a wide range of assets) by 2030. This target should be seen in the context of institutional investors' target allocations to private markets often being in the region of 20-30%, while Nest is targeting a 30% allocation when it reaches £100bn (around 2030). Data from CEM suggests pension schemes of around £20bn typically invest 20% in private markets.

If we are to address this long-standing mismatch, action is needed in all the following areas to have a significant long-term impact on pension returns:

1. Legislation and regulation focusing on performance
2. Consolidation of DC schemes
3. The Local Government Pension Scheme
4. Establishing new investment schemes
5. Venture capital: the British Business Bank
6. Venture capital: the funding ecosystem
7. Investment in UK businesses
8. Growing the pension pot

1. Legislation and regulation focusing on performance

- *Government policy needs to ensure UK pensions investment is focused on achieving the best long-term returns for savers and move away from short-term cost considerations.*

The UK pensions landscape is complex and there are a variety of policy choices that could drive the necessary scale and focus on performance. Whichever option(s) is chosen, the BVCA recommends the Government should follow these guiding principles:

- The interests of pension savers must come first and foremost.
- The focus should be on investing that maximises risk-adjusted net returns rather than minimising costs.
- Policy should facilitate an ecosystem that encourages pensions investment in the growth of UK businesses. If regulation and structure of the pensions market allows it, this investment is in the interests of savers, and the market should deliver it – as it does around the world.

- Regulation should be designed to make it easy for pensions to invest in smaller funds with regional economic impact.

The many regulatory frameworks which pension providers are subject to - including those overseen by the DWP, FCA and The Pensions Regulator - have played a role in nudging pension providers away from illiquid assets. Though pension providers have recently taken steps to address this, more can be done.

It is important that regulation continues to be shifted to enable – and where possible foster - this investment activity.

We believe well-intentioned regulatory and policy changes should not inadvertently encourage pension schemes away from private capital investments through lack of clarity or over-emphasis on short-term performance and risk.

Government policy and industry action needs to shift the balance of focus in UK pensions investment more towards achieving best returns for savers, and away from simply keeping costs as low as possible – active ownership and growing businesses can cost more but also drives higher overall returns.

Alongside the PLSA and ABI, we believe that helping DC decision makers to look at overall performance would encourage investment in higher performing private capital funds. This includes ensuring that the existing Value for Money (VfM) requirements for trustees are appropriately scrutinised and that the new VfM framework applies to both TPR and FCA regulated firms in the same way.

2. Consolidation of DC schemes

- *There are currently more than 28,000 DC schemes and 36 Master Trusts in the UK. While many of these are very small in scale, even some of the larger Trusts are too small to realise the Government's ambition.*
- *Consolidation and scale can be encouraged through an effective Value for Money framework, regulatory changes focused on consolidation, and awareness among trustees and advisers of the value of scale combined with private capital investment.*

If the Government wants to increase returns for savers and back UK businesses, the number of DC schemes in the UK needs to be reduced. There are currently more than 28,000 DC schemes in the UK, with three quarters of assets sitting in 36 Master Trusts.

While some Master Trusts are already consolidating, they are not currently achieving the scale needed to realise the Government's ambitions in this area. The commercial nature of the DC market means savers' interests are served by competition between providers, but 36 MTs is still too many.

There is more Government can do to accelerate this. It should learn from policy successes in countries like Australia and set out a roadmap to consolidate and increase the scale of UK pension funds. This would:

- Allow the concentration of expertise required to invest in private capital funds.
- Ensure the necessary diversification that would allow schemes to spread risks and solve liquidity issues.
- Alongside this, Government must consider mechanisms, including clear expectations and guidance, to ensure that pension schemes are able to invest in smaller regional funds that cannot accommodate individual investor commitments above a certain size. The experience of the LGPS in regional-focused investment should inform the Government's approach.

Achieving consolidation and scale

One way to accelerate progress towards consolidation and scale would be for Government to set a threshold for either the minimum size or diversification of assets pension schemes should hold, with a requirement to meet this by (say) 2030. This would send a clear message to the market about what is required to achieve the scale needed to support better governance, investment expertise and diversification of portfolio.

The minimum size threshold to achieve this should be informed by existing market experience. Nest has begun to make private capital investments with a scale of around £50bn and a forecast to pass £100bn assets under management (AUM) by 2030[5]. This would be consistent with the experience of Canadian pension schemes, which report realising significant benefits of this scale at an estimated Can$80bn, or £44bn at current exchange rate. Data from CEM suggests pension schemes of around £20bn typically invest 20% in private markets. The Government may consider a minimum threshold of around £20bn when the benefits of scale, in terms of substantial private markets investment, begin to be realised.

There are a number of other ways consolidation and scale could be encouraged. These include:

- Ensure the Value for Money (VfM) framework focuses effectively on overall returns for pension savers, rather than cost alone. This could alter the approach to long-term investment by schemes and employers and would set clear expectations, with potential regulatory interventions for those schemes identified as underperforming or having too much focus on short-term performance. This would be consistent with the recommendation made in Labour's Plan for Financial Services report proposing a role for The Pensions Regulator on consolidation.

[5] NEST press release, May 2024

- Implementing regulatory changes designed to encourage the direct consolidation of the small pots which make up a large part of the 28,000 UK DC pension pots.
- For those that are already achieving scale (including the Mansion House signatories), competition on performance rather than costs is key. This can be achieved through a combination of actions as set out in the Expert Panel report (see below).
- More broadly, 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 (which benefited hugely from the active engagement of officials and ministers) for the development of a template DC Request for Proposal for private capital investment, as a tool to bridge the language gap and 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 featured in the French Tibi scheme.

Implementing the measures outlined in this paper in full will represent a fundamental shift in the pensions landscape to fewer, more competitive DC schemes that are more focused on long-term returns and have better expertise in private capital investments. This will mitigate the potential for scaling to be done badly, which could risk less investment into venture capital, growth equity, impact or place-based investments, and the squeezing out of some ticket sizes or investment types. Again, the Government should learn from overseas examples cited in this paper where scaling and innovation in the pensions investment market on risk pooling has been achieved successfully and these risks avoided, and from the experience of the LGPS in this area.

3. The Local Government Pension Schemes

- *The UK's Local Government Pension Schemes are currently underinvested in private markets compared to other funds of their size.*
- *There are significant gains to be made from increased pooling and improved governance within the asset management approach taken within the scheme.*

The Local Government Pension Scheme (LGPS) in England and Wales has a combined value of around £350bn[6], placing it amongst the largest investors in the world. Asset owners of that size would usually be expected to have around 20-30% invested in private markets, however the LGPS has 6% in private equity.

[6] Local Government Pension Scheme Advisory Board

This discrepancy is due to several factors. Within the LGPS, pooling has made progress but is incomplete, covering less than 50% of assets. There is ongoing fragmentation, with 8 pools and 86 funds in existence. In addition, some of the pools have used a model that is not optimised for investing in private capital (as opposed to the approach taken by Border to Coast and LGPS Central, which is more akin to that of commercial asset managers).

To achieve the scale and performance desired in the Local Government Pension Schemes across the UK, action is needed in the following areas:

- Increased pooling: As with DC pensions, 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.
- 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).

4. Establish new investment schemes

- *When considering the creation of new investment schemes, the Government should draw on existing initiatives, including overseas examples such as the French Tibi scheme.*
- *The Government should facilitate a fund of funds (as proposed for the LIFTS program) to help DC schemes diversify and facilitate private capital investment.*

UK version of the Tibi scheme

The BVCA welcomed the recommendation in Labour's Start-Up, Scale-Up report[7] that Britain draws on the experience of the successful Tibi scheme in France to build engagement and understanding between institutional investors and venture capital firms. The proposals recognised the potential for such a scheme to directly facilitate investment and bring together UK VCs and institutional investors to collaborate and foster better mutual understanding.

A UK scheme designed around this model could also work as part of the remit of Labour's National Wealth Fund, or a scheme where DC pension funds would invest a proportion of their assets alongside the British Business Bank (BBB) into UK growth assets – mid-cap growth private equity and venture capital. These schemes would catalyse investment.

The BBB should be tasked with ensuring that the medium-term outcome is the closer link between institutional investors and the ecosystem that invests in growing UK firms, so that an eco-system of successful managers in private capital, and experienced investors in the pensions industry, can continue to grow over the long-term. The BBB's role should be seen as driving change, not as a substitute for change.

Accreditation

A simple accreditation process would build on learning from the French Tibi scheme. This should be an industry-led accreditation process, independent from Government and bespoke to the UK investment ecosystem, to give DC investors confidence in the assets and funds within the scheme. This should follow a principles-based approach and could draw on the BBB's expertise in due diligence and assessment of fund managers and products. This should also provide DC providers with some level of comfort on their investments.

A 'fund of funds'

In addition to backing these ideas, the BVCA has called on the Government to consider facilitating a fund of funds (as proposed for the LIFTS program), to help UK DC pension schemes invest in this space. The BVCA believes that this would help DC schemes to diversify, address operational challenges and allow schemes to partner with experts in illiquid fund management and VC manager selection.

5. The role of the British Business Bank

- *Action to address the scale-up gap in the UK should be coordinated with the BBB and its Growth Fund to avoid duplication of effort and overlap of purpose.*

The UK is the third largest venture capital hub in the world. £7.9bn was invested in UK tech-focused businesses by private capital investors in 2023, representing 39% of the total amount

[7] Labour: Start-up, scale-up report 2023

invested in UK companies[8]. Three in ten of UK's fastest growing companies were backed by private capital[9].

In the venture and tech investment ecosystem, the BBB plays a significant role in crowding in regional and growth funding, and it has a role to play in supporting the pensions and growth agenda. It has also supported the broader tech ecosystem during the pandemic.

Besides its role in lending to small businesses, the BBB is also the largest single investor/LP in UK-domiciled VC funds, largely through the Enterprise Capital Fund and British Patient Capital programmes.

The scale-up gap

Companies that look for significant investment pre-IPO, usually around £50m+, often struggle to find lead investors for these rounds in the UK. BVCA-commissioned research has found that the proportion of foreign investment in larger venture capital deals has increased since 2019. In 2023, 94.3% of deal value over £50m included foreign investors, compared to 89.7% for the 2019-2023 average.

This capital has come from the US or overseas and the BVCA has spoken to companies that secured the EIF as a lead investor. In this case, these companies have had to relocate from the UK to secure EIF investment, given the lack of options in the UK. Overall, this exposes the lack of available scale up investment in the UK, with insufficient funds of scale available to invest in deals over £20million.

This is a far from ideal outcome, both for the companies and UK investors. The creation of a new vehicle or scheme to facilitate pensions investment in high-growth companies should focus on developing the UK's investment ecosystem for investment at this stage, unlocking greater levels of domestic institutional investment.

Alongside this, it will be important for close coordination with the BBB on its ongoing work to develop the Growth Fund to avoid duplication and ensure cohesion of investment vehicles across the ecosystem. In the future, the BBB could take a more active role in catalysing the creation of larger VC and growth funds that can lead these rounds, and the BBB should have the ability to lead these rounds itself, so companies do not have to look to the EIF to secure investment.

6. Investment in UK businesses

[8] BVCA: Private capital: Building a better economy for the future report 2024
[9] The Times: 100 fastest growing companies in the UK 2024

- *Policy and regulatory efforts should focus on building scale and ensuring the investment infrastructure in the UK is geared towards facilitating pension fund investment, rather than a UK investment requirement that is not appropriate for the size of relevant funds.*
- *There are likely to be challenges to any requirement to invest in the UK that does not look to encourage investment into the types of funds that already have a UK bias.*

UK private capital funds typically invest around half of the capital they manage in the UK without any regulatory requirement to do so, and 85% of their capital base comes from around the world. Supporting UK-led private capital funds therefore means helping British business to attract global capital.

There have been some proposals and discussion around the possibility of rules requiring DC schemes and the Local Government Pension Scheme to invest in UK businesses, and potentially to publicly disclose their levels of UK investment. This type of blunt regulatory requirement is likely to face significant challenges, including overcoming challenges of the fiduciary duty of pension funds, and a risk of distorting the market.

There is also a lack of availability of UK-only investment funds on a large scale. Funds that have a UK focus tend to be at the lower mid-market size in the current market. As outlined above, a new Tibi-style scheme that works with the BBB and can address the scale-up gap can ensure this type of UK-focused scheme is built into the system alongside the drive for scale.

Overly prescriptive disclosures or restrictions around the investments UK private capital funds make will harm the international competitiveness of those same funds in attracting capital from around the world.

To ensure funds that currently invest in UK businesses do not gain UK institutional investment at the expense of losing international investment, it is important that they are not seen to be at risk of de-prioritising returns to investors in the face of other demands.

The focus should be on building the UK's private capital investment ecosystem, particularly at the scale-up stage where there is a lack of domestic investors. It is also worth noting previous proposals to require LGPS funds to invest 5% of their funds in projects which support local areas, something which would have been largely met through UK-focused investment policies of lower mid-market investment firms.

Getting more private capital firms and larger funds to be managed in the UK can be achieved through the measures set out in this paper, specifically:

- Building scale and proportionate governance requirements for domestic investors, including the LGPS
- Enhancing the role of the BBB to help crowd in investors

- Developing a Tibi-style scheme focused on the UK investment ecosystem

In practice, global diversification has to remain a key part of pension investment into private capital, as it is in countries such as Canada and Australia who have already achieved the type of scale and investment that delivers better overall returns for UK pension savers. Larger, active investors benefit from an element of geographical diversification in order to reduce risk. This is established good practice across the investment landscape.

7. Growing the pension pot

- *In the long-term, Government should consider lowering the pension automatic enrolment age from 22 to 18 to encourage greater savings and increase investment time-horizons.*
- *DC scheme providers should be encouraged to consider more "to and through" investing, to keep savers investment in private capital investments for longer periods of time.*

Over the long-term, getting people saving more and for longer into their pensions is clearly desirable. Alongside this, the outcomes of the Government's Pensions Review can help ensure that what people are saving is working harder for them through higher-performing investments.

Pensions providers could be encouraged to consider more "to and through" approaches that allow savers to benefit from growth assets like private capital investments. It is widely recognised that people need to save more, and start earlier, to build their pension pots. Government should consider lowering the automatic enrolment age from 22 to 18 because younger investors' longer time horizons mean they would benefit from a greater proportion of their portfolio in illiquid assets.

Where default lifestyle funds are used, these typically disinvest into predominantly cash and fixed interest assets from the age of 55 and would benefit from an earlier starting point to fit in with the time horizon and liquidity characteristics of private capital.

Industry collaboration: The Investment Compact for Venture Capital and Growth Equity

- *The recommendations of the Expert Panel should be adopted by Government and industry to capitalise on progress made through industry collaboration.*

The Investment Compact for Venture Capital & Growth Equity (the Compact) is a commitment by UK venture capital and growth equity fund managers to develop a long-term and constructive working relationship with UK pension investors. Through the Compact, the BVCA is enabling increased engagement with the aim of boosting investment in private capital. This mirrors and aims to support the joint public commitment by 11 of the UK's largest pension providers to invest 5% of their savers' default funds into "unlisted equities" by 2030.

Together with the Association of British Insurers, the Pensions and Lifetime Savings Association, and the broader pensions industry, the BVCA established an Expert Panel of senior pensions and private capital industry leaders to find solutions to technical, market and policy challenges.

Since January 2024, both the panel and a 50-person 'Technical Expert Group' have been working together to examine solutions to the issues and drive meaningful change in this space.

The interim report of the Pensions & Private Capital Expert Panel makes a series of recommendations that picks up many of the themes discussed in this briefing. The full interim recommendations are as follows:

- The pensions industry should be empowered by government and regulators to move away from short-term cost considerations to long-term returns by DC pensions.
- Consistent cost disclosure requirements must be applied across the investment ecosystem.
- The private capital and pensions industries should work together the develop a model Request for Proposal.
- DC schemes, platforms and advisers should use quarterly private capital valuations, alongside appropriate governance for unusual liquidity events, as a means of ensuring fairness between members in unit pricing.
- All parties should consider how far new and alternative approaches to fee structures might be made to work in savers' interests.
- As the Government explores the creation of a new investment scheme vehicle, it should draw on existing initiatives, particularly on overseas examples, including the French Tibi Scheme.
- The FCA should review the relevant regulations and processes to encourage more LTAFs to come to market.
- The FCA should review and amend the Permitted Links rules.
- Life platform providers must offer private capital options for DC schemes.
- Regulators should work with industry to provide reassurance and updated guidance on their liquidity expectations for how DC schemes should handle the stress events and their impact on liquidity.
- DC schemes should consider the role of "to and through" investing, with a view to keeping savers invested in private capital investments for longer periods of time.

- Industry and Government work together to determine how risk can be better pooled in DC structures, in the interest of savers. In particular, CDC schemes should continue to be explored.

These recommendations were published in the Panel's interim report in September 2024. They represent consensus across industry about more limited reforms which can be a first step towards the wider reforms considered by the pensions review and outlined above.

Conclusion

The Government's ambition for its Pensions Investment Review is to "boost investment, increase pension pots and tackle waste in the pensions system". If this ambitious agenda is successful, it will benefit UK savers as well as UK businesses.

Achieving this will require progress to be made in all the areas outlined in this report. Legislative and regulatory change alone will not achieve this, nor will simply consolidating DC schemes to generate cost savings, or encouraging people to save more into their pension pots. But taken together, the actions identified in this briefing can unlock significant investment for UK businesses, ensure the pension pots of UK savers work harder to give people the retirement they want, and make the UK a leading international example in pensions and investment.

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Annex 1

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 ecosystem 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.