DWP – Facilitating investment in illiquid assets

Response from Nest Corporation

1 About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Unlike any other pension scheme in the UK, Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 975,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high-quality, low-cost pension scheme helping over 11.1 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £20,600 per year on average and roughly 55% of our members are aged under 40 years old.

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We now occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.[1]

[1] Employer and member numbers correct as of 31/03/22, Nest in Numbers; Member earnings and age data correct as of 31/03/22, quarterly briefing data pack, Scheme MI.

2 Response

Introductory comments

We welcome DWP's disclose and explain proposals outlined in the consultation. Both are sensible measures that will add greater transparency to the DC market. By the same token, we do not believe the new reporting requirements would add substantial burdens to schemes. We support taking both proposals forward. The proposed requirement to add an illiquid asset investment policy to the Statement of Investment Principles (SIP) should focus some Trustees on illiquid investments and encourage further education about more diverse asset classes. We see both proposals as reasonable measures in attempting to refocusing the DC sector on value and drive member outcomes through higher risk-adjusted returns.

We are also strongly supportive of DWP's proposal to amend the employer-related investment (ERI) regulations. As currently constituted, the ERI regulations impose significant costs on Master Trusts without delivering the consumer protection the policy is designed for, which was aimed at single or group employer pension schemes. The ERI regulations were implemented before the advent of Master Trusts and were not designed with the kind of multi-employer provision automatic enrolment has ushered in. The regulations severely limit the ability of Master Trusts to invest in certain asset classes or via certain legal vehicles and, when not prohibitive, create compliance costs that are borne by scheme members. The proposed amendments to the regulations allow Master Trusts to consider a broader range of asset classes to meet their memberships' needs whilst still maintaining protection for members in line with the policy goals of the original legislation. We note, however, that the proposed regulations could be further simplified to meet the policy objectives behind the proposal.

Disclose and explain policy proposals

Question 1: Do you support these proposals and agree with the government's rationale for intervention?

We support DWP's disclose and explain proposals and broadly agree with DWP's rationale for intervention. We agree that investment in a wider range of asset classes – including the illiquid assets covered by the proposals – provides an opportunity for DC schemes to deliver higher risk-adjusted returns to their members and improve member outcomes. The proposed measures may facilitate greater consideration of illiquid assets by Trustees and, at a minimum, will likely require Trustees to become more familiar with a broader range of asset classes as part of their investment strategies.

We also strongly support DWP's rationale for not prescribing any specific asset allocations. As the consultation notes, doing so would create potential conflicts for Trustees in adhering to their fiduciary duties to members. Maintaining trustee independence in fulfilling that obligation is essential.

We think DWP is also correct to acknowledge the potential limitations of these proposals. As the consultation recognises, the disclose and explain measures do not represent a 'silver bullet' for removing barriers to investing in illiquid assets. Many schemes will still avoid illiquid investments for a variety of well-documented reasons. Other schemes merely outsource the formulation and execution of investment strategy and may not be affected by the proposed measures. In our view, however, the proposals represent a sensible step that should not require significant additional resources to comply with.

We would also note the potential limitations for improving competition amongst schemes based on illiquid investment strategies. Whilst we agree that greater transparency could allow for more

meaningful comparisons of schemes across the industry, we are not sure this will have a significant effect on employer or consultant decision-making. Similarly, experience with our own members suggests that increases in member engagement due to greater transparency around illiquid investments may also be limited. We do not, however, see these limitations as sufficient reasons not to take the disclose and explain proposals forward.

Question 2: Do you agree with the scope of this proposal?

Yes, we agree that the proposals should only apply to occupational DC schemes and to default arrangements only.

Question 3: Considering the policy objective to require trustees to state a policy on investment in illiquids, how should we define “illiquid assets”?

DWP correctly notes the difficulty in arriving at a definition of ‘illiquid assets’ for the purposes of the disclose and explain proposals. There is no accepted definition within the investment industry. With this in mind, we would support a definition based on a common-sense approach in which Trustees designate the assets that they deem to be illiquid. This determination could be supported by the publication of additional guidance, but there is already an accepted informal conception of illiquid investments – those constituting either or both of real assets or private/unlisted assets. Whilst this approach may sacrifice consistency, it would allow Trustees to retain more flexibility and discretion in fashioning an investment strategy. Moreover, this type of approach would still meet the policy goal of facilitating greater consideration of illiquid investments by Trustees. Alternatively, DWP could adopt a definition in line with the definitions of the IFRS 13 accounting standards, assigning assets to Level 1, 2 and 3 under that approach.

We would note that a proposed asset class taxonomy which included simply ‘property’ and ‘infrastructure’ could prove ambiguous, as schemes who publish their asset allocations today commonly carve out listed real estate (REITs) as 'property.’ This should not be conflated with illiquid/direct property investments.

Question 4: Do you agree with the proposed aspects of a scheme’s illiquid asset policy that we would require to be disclosed and timing of such disclosures?

Yes. We agree with the proposed elements of the disclosure of a scheme’s illiquid asset policy and the timing of the disclosures to coincide with the current SIP disclosure requirements. These aspects of the proposal seem to strike a sensible balance between the resources required to comply and the value to be gained.

Question 5: Do you agree with the proposed level of granularity for this disclosure? Are the asset classes and sub-asset classes proposed in the example above appropriate for this kind of asset allocation disclosure?

Yes. We broadly agree with the proposed level of granularity, though we would note points made in Q3 again. The seven main asset classes should provide sufficient information to allow for comparisons across schemes, with encouragement to provide more detail on different elements within those asset classes. We would note that additional guidance will likely be required to ensure that investments are reported consistently. For instance, in many cases property or infrastructure should be reportedly separately, or as another asset class (e.g. private equity) depending on how the investment is structured.

Question 6: Do you agree that holding £100million or more of total assets is an appropriate threshold for determining which DC schemes should be required to disclose asset allocation?

We do not agree with the proposed £100 million threshold for the asset allocation disclosure. We do not believe the resources required for compliance with the proposal are prohibitive and see no reason why

schemes should be exempted. To the extent that publishing asset allocations allows for scheme comparisons, those comparisons should be made uniformly across the DC sector.

Question 7: Do you agree that we should align the disclosures with the net returns' disclosure requirement?

For the sake of consistency across reporting requirements, we support alignment with the net returns' disclosure requirement for members aged 25, 45, and 55. This may reduce any resource burdens associated with asset allocation disclosures. However, we would urge further consideration of 'years to retirement' disclosures. These more closely align with the how members proceed through scheme glidepaths and may thus be more meaningful points of comparison.

Question 8: Do you agree with the frequency and location of the proposed asset allocation disclosures?

Yes, we agree that the asset allocation disclosure should be made annually in the Chair's Statement.

Question 9: Please provide estimates of any new financial costs that could arise from the proposed "disclose and explain" requirements. Please outline any one-off and ongoing costs.

No comment.

Employer-related investments

Question 10: Do you think the current regulations relating to ERI in the 2005 Regulations present a barrier to Master Trusts expanding investment strategies to include private debt/credit?

We agree that current ERI regulations are problematic for Master Trusts and do not provide any additional protection for members of these schemes. Restrictions on ERI are designed to address the concern that a large proportion of a scheme's assets could be invested in the sponsoring employer or affiliated entity, leading to a risk that funds would be misappropriated, or that scheme members potentially faced the double whammy of losing their job and their pension. However, for large Master Trusts the proportion of funds invested in any one underlying asset is very small and participating employers have no control over those underlying assets. As a result, the harm the legislation seeks to protect members from is negligible, but the regulations impose a significant cost on schemes and discourage schemes looking at the full range of asset classes that may help to achieve a scheme's objectives.

As DWP recognises, these additional costs present a barrier to investing (or expanding investment) in certain assets. First, ERI regulations limit investment in assets such as private credit. Employer-related loans are prohibited unless structured as a collective investment vehicle. In recently procuring a public credit mandate, we were able to compare directly the difference in cost between pooled and segregated mandates (we asked for bidders to price up both). The additional cost of setting up a pooled fund – as required by ERI legislation – was typically between six and nine basis points (and sometimes more), thus adding a significant incremental cost to our private credit mandates. This in turn constrains the amount we can invest in this asset class. This issue will also affect future opportunities we are pursuing in asset classes such as private equity, which is part of HMT's patient capital agenda. Similarly, as DC assets in Master Trusts reach scale, Trustees may decide direct investment in infrastructure, for example, may be in the best interests of their members, as exemplified by the large superfunds in Australia. The ERI rules could prevent Nest from doing this even where it is clearly in the best interests of our members.

Second, the current ERI regulations require additional resources be dedicated to ensuring compliance. For schemes with a large number of participating employers, this compliance exercise is costly and

impractical – and was never the intent of the original legislation or the IORP Directive. In the case of Nest, this means monitoring potential investments and comparing those to Nest's list of nearly one million participating employers. Whilst compliance is required in terms of direct lending/private credit, many high-yield bonds also fall within scope of the regulations given that they are not listed on a recognised exchange. We have thus instituted a pre-approval process for investment in these types of bonds. Ultimately, the additional costs from ensuring compliance are passed on to members. Finally, we would note that many private equity and venture capital deals in the UK utilise convertible loan instruments rather than common equity in the initial phases of funding – as such PE/VC would also fall within the scope of ERLs that need to be monitored and excluded.

Question 11: Do the draft regulations achieve our policy intent?

In our view, the draft regulations go most of the way to achieving the policy intent by bringing down investment costs and widening the investment opportunities for master trusts to the benefit of members. We would suggest that the one risk that remains to the policy intent, however, is in relation to the ongoing retention of the "connected or associated" test for master trusts. This test can be very difficult for master trusts to apply with certainty and may result in unintended breaches on investments even where robust monitoring procedures are put in place.

Given that for employer related loans a breach automatically means a criminal offence – even if it's minor and unintended – then without the certainty that a monitoring procedure can detect minor breaches before they occur, some master trusts may still choose to simply not take the risk to invest in private credit. Certainly, some master trusts may avoid private credit mandates where there are multiple changing investments, less control over fund managers (who will be making the active investment decisions not trustees), or where there is restricted ability to undertake the monitoring of "connected or associated" in real-time before investments are made by fund managers.

This may dilute the policy intent somewhat. There is also the issue of the ongoing changing of personnel at Scheme Funders and Scheme Strategists. The connected and associated test will need to be re-applied to new individuals as and when recruited to the Boards of these entities (many of whom will have roles on boards elsewhere – which is usually a positive thing in terms of providing valuable experience and expertise), which perversely could mean current illiquid investments are suddenly in breach and need to be disinvested (which by their nature may be difficult in some cases). This is despite the good reasons for their initial investment not having changed.

We understand that important safeguards need to be put in place but would propose something simpler to prevent the above challenges due to the low-risk nature of master trusts of this size. One suggestion would be to use "holding company" and "subsidiary" in the Companies Act 2006 rather than the "connected or associated" test. This would be simple to monitor and would give master trusts the confidence they could invest in private credit with a very simple exclusion list given to their fund managers. This exclusion list would be unlikely to change very regularly and, if it did, would be done with full awareness of this risk.

Question 12: Do you agree with the information presented in the impact assessment?

No comment.