DWP Investment Innovation and Future Consolidation

Consultation response from NEST Corporation

About us

NEST is a UK delivery success story. Established in 2010, NEST has been a critical pillar of the government's auto enrolment programme, with a public service obligation to accept any employer wishing to use the scheme to discharge their auto enrolment duties.

From a standing start, we have delivered a high quality, low cost pension scheme open to all which has not only delivered on its mission, but helped to drive up standards and best practice across the industry. Now with over 7 million members, NEST is playing a critical role in helping people save for their retirement - many of them low to moderate earners who may be saving for the first time and moving jobs frequently.

NEST now occupies a place in the market as a major Master Trust, a sector that has grown following the introduction of auto enrolment - and that we believe has great potential for delivering pensions to mass market consumers for many years to come, leveraging scale to offer low cost, modernised services in the context of strong Trustee governance.

Introduction

Nest welcomes the DWP consultation on investment innovation and scheme consolidation. Our members are at the forefront of our investment approach and our ambition is to deliver good outcomes through strong risk adjusted returns. Illiquid investments, such as infrastructure equity, represent an opportunity to improve the retirement outcomes for DC scheme members.

We welcome the Government's commitment to overcoming the barriers for DC schemes to invest in more illiquid and higher risk asset classes. Nest has contributed to this work through our participation on HMT's Patient Capital Taskforce and ongoing work with the British Business Bank. Increasing the flow of investment by DC schemes into illiquid assets is a potential win-win for our members; new sources of growth and improved long term returns as well as the related benefits of helping to grow the UK economy.

Nest has been able to leverage its scale to access some illiquid assets within our current budget constraints. However, to unlock the potential returns from Patient Capital and satisfy the growing demand from DC schemes, we encourage the Government to further consider the calculation of the charge cap for DC scheme default funds. Without changes to the calculation, the interaction between the charge cap and performance fees will continue to limit the range of illiquid assets that DC schemes can invest in.

Responses to specific questions

Reporting on illiquid investments

Q1 We would welcome comments on the following proposals around reporting pension schemes' approach to investing in illiquid assets. We would also welcome any other proposals which use reporting to prompt consideration of illiquid assets

1. **Scope:** 'Relevant schemes' (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 or 20,000 or more members (or alternatively £250m or £1bn assets to provide for money purchase benefits) would be in scope of the proposed requirement. Would an asset-based or a membership-based threshold be more proportionate and effective?
2. **Reporting their policy:** Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles
3. **Reporting their actions:** Schemes in scope would be required to report annually on their main default arrangements' approximate percentage holdings in illiquid assets, and with a breakdown in holdings of the trustees' choosing.

Scope:

Rather than being prescriptive about size or asset-base of relevant schemes, the onus should be on the operators of a scheme to give members as much information as they need and as much asset liquidity as possible to satisfy liquidity needs. We find the points in the consultation document about disclosure anomalous because we believe that all schemes should disclose their asset allocation from which it should be evident whether investments are assets that are liquid, illiquid or somewhere in between. Nest does this on a quarterly basis in our quarterly investment reports, and our Statement of Investment Principles (SIP) lists all the asset classes we are permitted to invest in.

Reporting policy:

Schemes are required to publish online their Implementation Statement and the SIP, phased in from October 2019. Nest already publishes these documents including detailed information about our asset allocations on a quarterly basis.

Rather than mandating what schemes should state in relation to illiquid investments, we believe that a scheme's approach to illiquid investments can be inferred from what they state in the SIP. Schemes should be encouraged to provide more detailed and regular breakdowns of asset allocations as best practice. This will allow customers (be it employers, advisers or members) to understand how the scheme invests, whether it is realistic to expect that strategy to achieve its investment objectives and whether it is providing value for money.

Reporting actions:

Some schemes will already be reporting on asset allocation at a sufficiently granular level in terms of the percentage of holdings in illiquid assets and a breakdown of those assets. It is noted in the consultation document that some flexibility will be permitted in the interpretation of the definition of illiquid assets. We are concerned about how appropriate it is to ask schemes to distinguish between illiquid and liquid asset allocations because this is subjective and imprecise.

We would agree that more quantitative data should be signposted from the SIP.

Encouraging consolidation

Q2 Do you think Government should encourage or nudge smaller occupational DC pension schemes to consolidate? If this should only happen at some point in the future what factors should be taken into account in determining that point?

Both large and small pension schemes can be well run but there are demonstrable benefits to scale that are harder to achieve in small schemes. The move to scale can support lower administration and investment costs, improve governance practices, access to expertise, and greater portfolio diversification. However, scale is not enough on its own to guarantee good outcomes. Quality of governance is crucial, so it is important that consolidation, if it is encouraged, occurs into well run pension schemes that are committed to continuous improvement.

Schemes such as Nest with well diversified, risk-managed funds have traditionally only been available to higher earners. Our scale allows us to provide a sophisticated investment approach and negotiate good deals with partners. All this has been achieved at a low cost to members. As we increase in size we hope be able to influence companies to make sustainable business decisions to improve long-run returns for members.

Master Trust Authorisation will drive considerable consolidation in the coming months. It may be appropriate to reflect further on consolidation after that process is complete. Members of master trusts stand to benefit from consolidation because of the economies of scale it will bring. Large and well-governed master trusts can minimise operational costs thus delivering value for money for members. This improves the quality of service for both members and employers.

The key factors when considering motivating consolidation should be quality of governance, scheme performance in the default fund, quality of scheme administration and whether costs and charges represent value for money for members.

Q3 We would welcome views on the following proposals around pension schemes reporting their position on the potential benefits of future consolidation, or any other associated proposals.

1. Scope: ‘Relevant schemes’ with fewer than 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.
2. What should be reported: Schemes in scope could be required to explain their assessment of whether it would be in members’ interests to be transferred into another scheme with significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?
3. Reporting vehicle: The requirement could be added to the value for members assessment which forms part of the Chair’s Statement and published annually.
4. Updating frequency: The explanation of whether it is in members’ interests to consolidate should be updated at least every 3 years, and after any significant change in size or demographic profile?

1. We have no comment on the scope of relevant schemes
2. Government or regulators would need to issue clear guidance on how schemes should measure and report on member interest. Without guidance there is a risk that schemes could cherry pick what they perform well at and omit areas where they perform less well, but which might ultimately be of greater value to members.
3. We have no comment on this proposal
4. We have no comment on this proposal

Q4 What do you think about the use of indicators such as trustee knowledge and understanding, open or closed status or member demographics to identify and encourage schemes to consider consolidation? What indicators do you recommend and how could they best be communicated and verified?

We do not have a view on the indicators schemes should use when considering consolidation.

Performance fees & charge cap

Q5 To what extent are performance fees used or required for funds which offer illiquid investment such as venture capital, infrastructure, property, private debt and private equity? Are market practices changing?

Nest has been investing in direct illiquid UK property for several years and is in the process of appointing a number of private credit managers. To date we have been able to negotiate access to these illiquid assets for competitive base fees at the level we need to keep costs at an acceptable level to members and within our investment cost constraints which are significantly below 30bps without paying performance fees. It is conceivable, but by no means guaranteed, we may also be able to do so for infrastructure equity. So, to some extent market practices are changing, but it should be borne in mind that Nest has a strong and exceptional negotiating position, given its growth potential, and other smaller schemes will unlikely receive as favourable terms.

However, while we may also be able to persuade private equity (PE) and venture capital (VC) managers to offer lower than standard fees, the workload for the managers involved in managing such investments means, on average, fees will need to be higher than private credit and property. We do not believe that shifting PE and VC managers completely away from performance fees (or carried interest as it known for these assets) is likely in the near term.

Q6 To what extent is the charge cap compliance mechanism a barrier to accessing funds which charge a performance fee? Does this act as a barrier to accessing certain asset classes?

We believe that our members should have access to a high-quality investment approach. Government is seeking to encourage investment in illiquid assets and our approach and ambitions are completely aligned with this. We believe that by investing in certain illiquid assets we can improve member outcomes due to:

- Increased expected returns due to accessing the illiquidity (and complexity) premium
- Smoother returns due to improved diversification
- Accessing return enhancing opportunities in attractive industries and sectors which are hard to access in public markets (e.g. UK and European technology, biotech, renewable energy etc) – areas of immense opportunity in the UK economy
- Deploying capital to long term projects such as the greening of the economy, which have additional benefits for our members' retirement outcomes

Looking at the international experience where no charge cap exists, we can see that well run and highly regarded pension schemes in Canada (DB), the Netherlands (collective DC) and, most pertinently, Australia (DC) make extensive use of illiquid investments. In contrast, as the government has noted, there is a significant lack of investment in illiquids by DC schemes in UK, even though Nest is to some extent bucking this trend.

We believe that investing in VC, growth-oriented PE and infrastructure will benefit our members. However as mentioned above, it is unlikely they will be able to do so within the context of the default

fund (held by 99 per cent of our members). Even if we can negotiate sufficiently low base fees to make more illiquid assets affordable, because there will be associated performance fees and carried interest we will certainly exceed our budget in years when performance is good.

Under current rules, schemes can invest in private equity and infrastructure in an unconstrained way by investing in listed investment trusts dedicated to those asset classes, because the fees, carried interest etc are all buried within the share structures, being company costs, and are shielded from the charge cap calculation. We realise there is potentially a danger of regulatory arbitrage that government is looking to close by regulating a look through on fees for certain shares (associated purely with financial rather than real assets). While we are sympathetic to government's intent in this regard, we would caution about the potential unintended consequences of this move: i.e.

- while it is clear that an investment trust is investing in real assets (such as a REIT) is excluded and a fund of private equity funds investment trust is within scope, there may be significant grey areas as to whether an investment trust is within scope (e.g. an infrastructure trust investing in both equity and debt)
- the look through would be very complex and disproportionately expensive given in general only small amounts of money are allocated to such assets
- investment in such vehicles may be unavoidable if they are part of an index which is being tracked passively
- investment trusts can be a source of creating long term capital for long term illiquid investments and the regulations may distort capital allocation and stifle innovation (e.g. undermining the creation of a social impact investment trust which is currently being considered)

Q7 Do you agree that we should permit the additional method of charges assessment? Do you envisage any problems with complying with this method of assessment, or any reasons why it might disadvantage members?

We have no comment on the additional method of charges assessment.

Q8 We propose that:

1. We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.
2. We should in particular specify in statutory guidance that performance fees should be calculated and accrued each time the value of the fund is calculated.
3. Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees?

1. We agree that the Government should issue guidance on how investments with complex fee structures could be integrated into the default funds of DC schemes. Such guidance should carry statutory weight whilst recognising the primacy of trustee decision making.
2. Any guidance on performance fees should disincentivise excessive risk taking by fund managers and ensure that fees are levied in such a way that only members who have benefitted from outperfomance are subject to them.
3. We would welcome further clarification from DWP on the proposal to permit performance fees only by schemes that levy a single charge on members i.e. a percentage of funds under management. Nest levies an asset under management charge combined with a percentage contribution charge and are comparable with a 0.5% AMC. Indeed, Nest's charging structure offers potentially better value for money than a 0.5% AMC for our scheme membership, whose profile tends to be younger and lower earning.

We would not anticipate any schemes charging members a performance fee at the level of the scheme's default fund, rather that performance fees would be charged at the asset building block level.

Were Nest prohibited from paying performance fees whilst other schemes with single charges are permitted to use them, this would present a significant discrimination against the largest DC scheme by membership. It would severely inhibit the potential for members to benefit from asset diversification. It would also undermine the contributions Nest has made to date through participation in the Patient Capital Taskforce and the ongoing work with the British Business Bank.

Q9 Do you believe that the updated non-exhaustive list of costs and charges provides increased clarity about the scope of the charge cap? Are there any areas where further clarity might be required?

We have nothing further to add to the list.

Impacts of proposals

Q10 We would welcome views and any estimated costing for the impacts of these proposals?

1. Stating a policy on illiquid holdings
2. Reporting on illiquid holdings.
3. Considering and reporting on whether it might be in members' interests to consolidate
4. The additional method of assessment with the charge cap.

We have no comment on the estimated costs associated with these proposals.

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