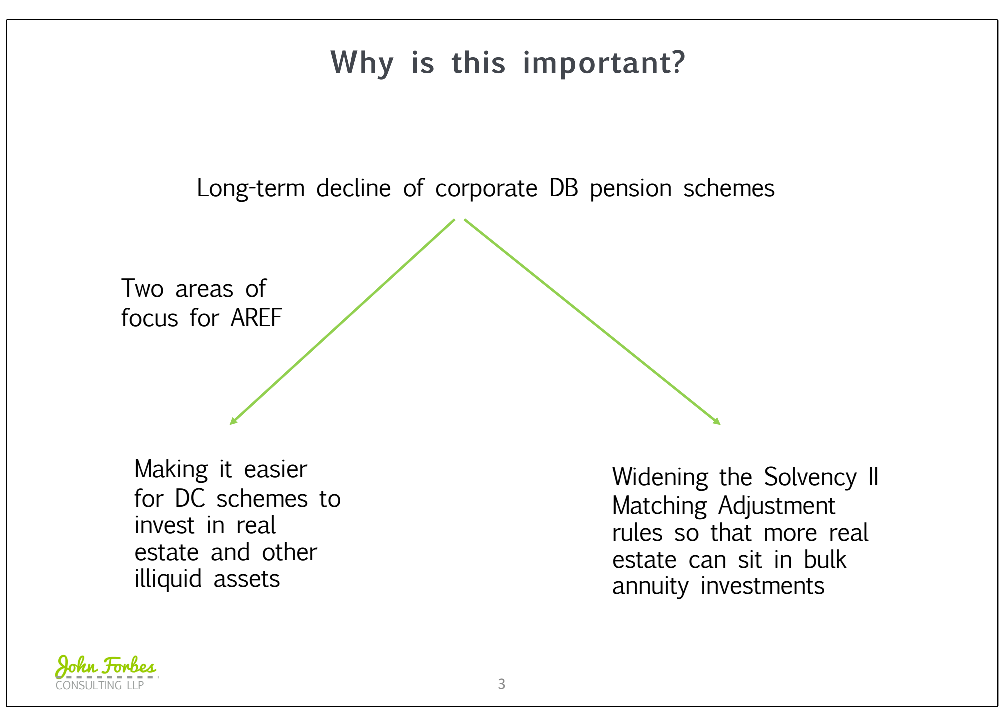
DB & DC Pension Schemes, Life Insurers and Illiquid Assets

5th July 2023

DB & DC Pension Schemes, Life Insurers and Illiquid Assets

- Why is this important?
- Reform of DC pension rules;
- Changes to the “permitted links” rules;
- Collective DC;
- The Long Term Asset Fund (LTAF);
- Life insurance and Solvency II;
- The Financial Services & Markets Bill.

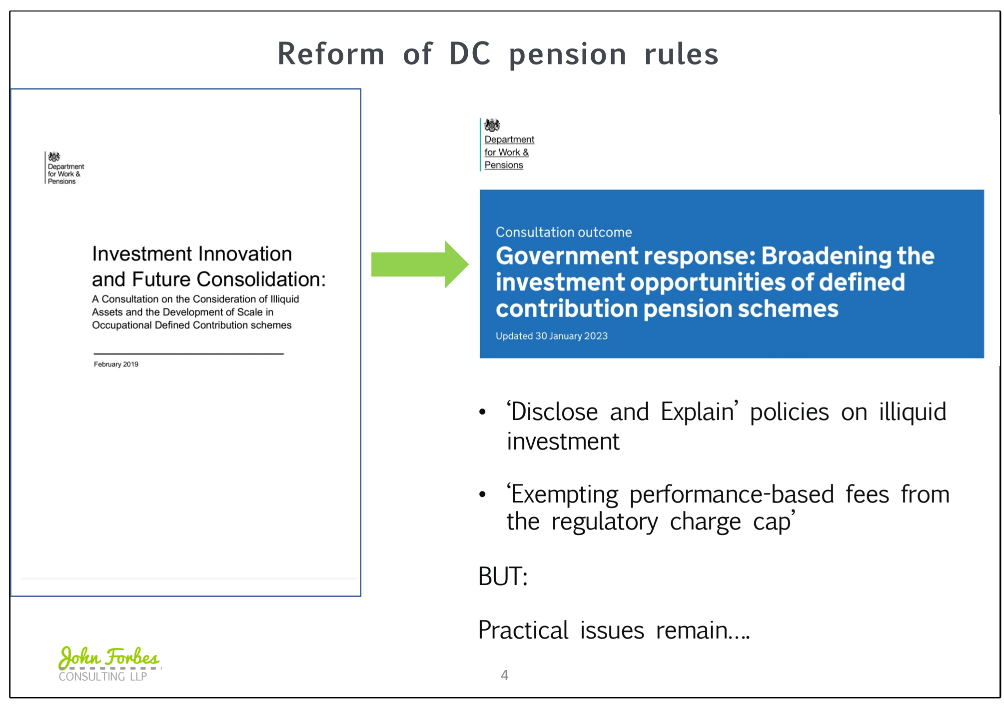


Why is this so important?

The long-term decline of corporate DB pension schemes has accelerated since Autumn fiscal event and the fallout from liquidity crisis in liability driven investment. DB schemes are de-risking, heading into run-off and transferring liabilities into the insurance bulk annuity market.

We have been lobbying in two key areas that are important as a result of this:

- Making it easier for DC schemes to invest in real estate and other illiquid assets;
- Widening the Solvency II Matching Adjustment rules so that more real estate can sit in bulk annuity investments.



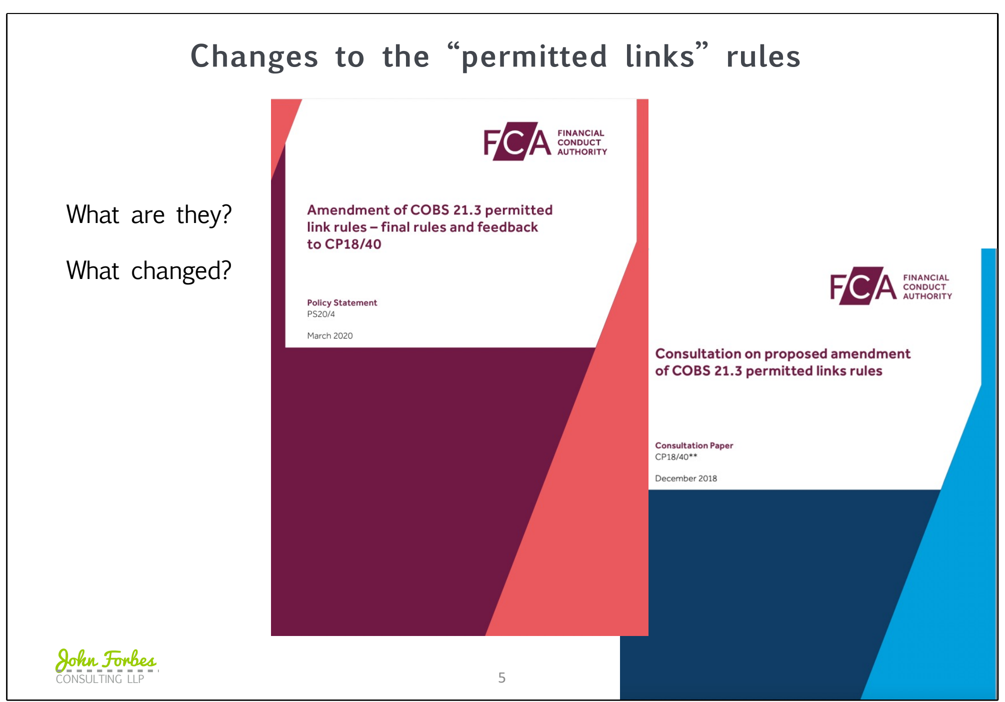
AREF have responded to DWP consultations on DC pension reform over several years. The final rules were published in January. There are two key areas of change:

Firstly 'Disclose and Explain' policies on illiquid investment. These will apply to the vast majority of schemes, which will be required to disclose their policy on investment in illiquid assets within their Statement of Investment Principles, and to require DC schemes to publicly disclose their asset allocation in their annual chair's statement. This comes into effect from October this year. I think this is important as one of the reasons widely cited for DC schemes not considering investments in illiquid assets is just inertia.

The second important area is 'Exempting performance-based fees from the regulatory charge cap'. This could be a whole session in its own right. The principle had been agreed already, the January update was dealing with a series of technical points including the treatment of fund-of-funds, carried interest etc.

The whole question of fees remains an issue for DC investment. In January, the DWP published a consultation, *Value for Money: A framework on metrics, standards, and disclosures.* The key concern it cited was that engagement with stakeholders and responses to the pension charges survey *shows that considerations of cost can dominate decision-making in many pension schemes, especially with some contracts now being won or lost over very small differences in cost. While costs are important, too much emphasis on cost can be detrimental to savers.* A greater focus on investment performance and value for money rather than cost is potentially a major step forward. The consultation closed at the end of March and the outcome is awaited.

Generally on DC schemes investing in real estate and other illiquid assets, practical issues remain, particularly around the role of the platforms. Platform architecture often problematic for funds that are not daily traded. The Productive Finance Working Group published its comprehensive guides for DC schemes, *Investing in Less Liquid Assets – Key Considerations - https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2022/Investing-in-less-liquid-assets-key-considerations.pdf*

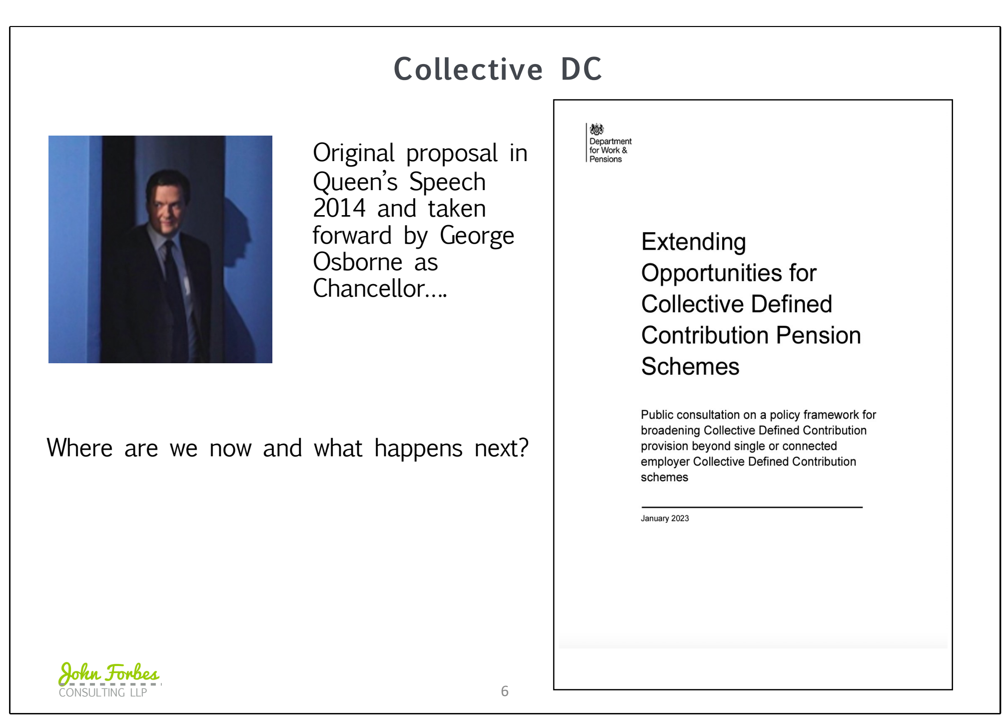


Another important change was to the permitted links rules in COBS 21.3.

The "permitted links" rules apply to unit-linked products that are sold by life insurance companies which have underlying pooled investments linked to an insurance policy. This allows investment by retail investors and is also important for DC default funds, although the permitted links rules were never as restrictive as some schemes seem to have assumed.

Following consultations new rules extending what qualifies as a permitted link came into effect in March 2020. This permitted a wider range of illiquid investments and the definition of land and buildings expanding to include physical infrastructure.
A further change was the introduction of the LTAF, which is expressly a permitted link.

This has been a long process as the first AREF meeting with the FCA on this was in 2012.



The next important change is the introduction of what is referred to as collective DC or collective money purchase pension provision. The original proposal was in the Queen's Speech 2014 and taken forward by George Osborne as Chancellor, always a good excuse to use my favorite sinister photo of George Osborne from the 2014 Conservative Party conference.

The first stage of CDC came into effect in August 2022, initially for the Royal Mail but also for single employer schemes more generally. A consultation has taken place on extending this to multi-employer schemes. We are still awaiting the outcome of this.
This potentially has significant benefits for investment in illiquid assets.

Firstly assets and liabilities are treated on a pooled basis rather than each policy-holder being treated as having their own individual pot. This makes it easier to hold illiquid assets and illiquid assets can be held longer-term as there is no need to switch into an annuity on retirement. Even within a single-employer scheme, this should allow more investment in illiquid assets.

Secondly, the benefits expand with multi-employer schemes. It would be possible to have industry-wide pension schemes, which could reduce volatility. People tend to change employer more frequently than they change industry.

Not everyone is convinced that CDC will make much difference. My own, personal view, is that it could be a game-changer, but it will take a while.

The LTAF

The long-term asset fund (LTAF);

Designed as a DC specific product;

FCA conclusions on extension to retail investors published last Thursday.

John Forbes
CONSULTING LLP

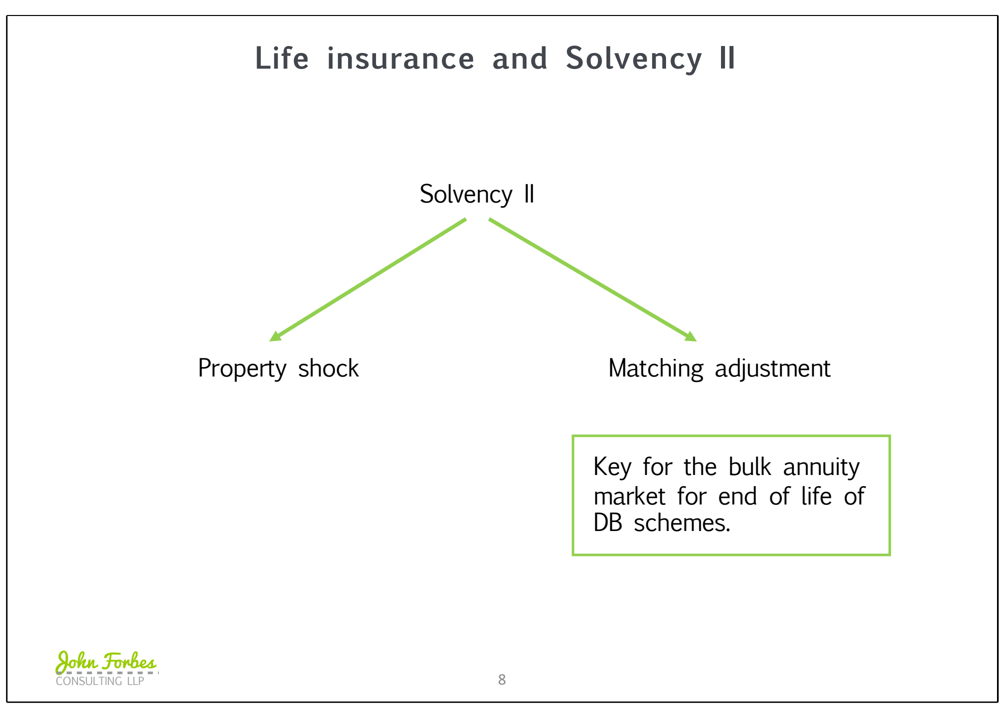
7

The Long Term Asset Fund (LTAF) was introduced on 15th November 2021 by the *Long-Term Asset Fund Instrument 2021.* It has taken a while for this move from theoretical to impending reality, with Schroders Capital and Aviva Investors obtaining FCA approval for the first two LTAFs in April.

The LTAF was designed as a DC specific product and is a permitted link.

The other significant development was the publication last Thursday of the FCA conclusions on the extension of the LTAF to retail investors. I think this is important as I see the intermediated retail market as a big area of focus in the coming years.

That is the end of the DC part. As I mentioned at the start, the other leg of all this is the potential changes to the rules for life insurance companies.



The other area to cover is changes to the capital requirements for insurance companies.

The regulation of insurance companies is governed by the EU Solvency II Omnibus II Directive. HM Treasury has been reviewing potential changes to make the UK Solvency regime more flexible.

We have been lobbying on two aspects, which are important for real estate as an asset class.

Firstly, a reduction in the property shock under the Standard Model from the current 25% on the basis that the shock is modelled over too short a period (one year) when real estate investments are held for much longer than this. Progress on this has been limited.

Secondly, changes to the matching adjustment rules that allow assets that match liabilities to be excluded from the Solvency Capital Requirements. In November 2022, it was announced that the rules would change such that the requirement would be for returns that are "highly predictable" rather than "fixed". The examples provided by HMT related to infrastructure.

Along with the British Property Federation, we have been lobbying HMT and the PRA to ensure that when the final rules are published, it is made clear that real estate is also eligible. Introduction of this is dependent on the Financial Services and Markets Act.

The Financial Services & Markets Act 2023

- Key to a number of changes, including Solvency changes and the Reserved Investor Fund, which can now be introduced by Statutory Instrument;
- Received Royal Assent last Thursday (29th June).

The Solvency changes and a variety of other things have dependent on the Financial Services and Markets Bill which had been working its way through the parliamentary process since July last year. It received Royal Assent on 29th June and is now the Financial Services and Markets Act 2023.

It allows financial regulation to be introduced by statutory instrument. Changes to the Solvency regime are slated for immediate progress.

www.johnforbesconsulting.co.uk

This presentation has been prepared for general guidance and does not constitute professional advice. You should not act upon the information contained in this presentation without obtaining professional advice. No representation or warranty is given as to the accuracy or completeness of the information contained in this presentation. To the extent permitted by law, John Forbes Consulting LLP and its members do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this presentation or for any decision based on it.

© 2023 John Forbes Consulting LLP.