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The Honourable Minister for Pensions, Emma Reynolds MP**,**
The Pensions Investment Review teams at DWP and HMT,

Submitted by e-mail to: quarryhouse.pensionsinvestmentreviewdcreforms@dwp.gov.uk

Dear Minister and DWP and HMT review teams,

CFA UK and CFA Institute's letter in response to the Pensions Investment Review, Phase 1

The CFA Society of the UK (CFA UK) and CFA Institute (CFAI) welcome the research and consultation materials provided as part of the Pensions Investment Review, Phase 1.

CFA UK's purpose is to grow talent, and many of our members work in the UK pensions industry, either directly as managers, trustees, or consultants or in companies providing investment services to UK pension funds. CFAUK and CFAI have consistently supported the development of the pensions sector, including advocating for a long term perspective, value for money for investors, and independence and skills of Trustees.

We have not responded to the two specific open consultations, as in both Defined Contribution (DC) pensions and Local Government Pension Schemes (LGPS) your focus is on the mechanics of consolidation, which is a technical area others are better suited to feedback on. ***We however wish to make some key points that we believe should be considered in the overall pensions review.***

1. PRIMARY RATIONALE FOR CONSOLIDATION

We support the direction of travel of the consolidation initiative, subject to effective management of the key risks we have highlighted under section 3. Below.

However, the ***Primary Rationale for consolidation should be to further the interests of scheme beneficiaries,*** which also aligns with the fiduciary duty of Trustees. Therefore, the expected consequence of better (net of cost) returns should be clearly stated, noting that in the current materials there is limited reference to this objective. The thesis would be:

Consolidation → Economies of scale & diversification into private and specialist classes → Cost savings and Better long term returns → Higher net returns for investors

Please refer to a previous report from CFAI (link below) that supports increased private market allocation by DC schemes and the "*pooling of resources*," but calls out key issues that need to be addressed to facilitate this, for example:

- Value for money (where the UK is making good progress)

- Disclosure by private markets (to slot easily within a pensions disclosure framework)
- Inherent illiquidity of private investments
    - capital-formation-investing-pension-contributions-in-private-markets.pdf

Similarly, the latest Mercer-CFAI pensions survey (link below), agrees that it is "*appropriate for the investments of pension plans to be diversified across a range of asset classes, thereby providing the opportunity for higher returns with reduced volatility*"

- mercer-global-pension-index-2024.pdf

We note that ***the cost of consolidation is borne by investors***. When merging asset classes, managers, and strategies, estimates of (one time) trading costs can be material. The long term benefits of consolidation for scheme beneficiaries must also cover the one-time costs.

Encouraging higher relative investment in the UK from the UK pensions pool is a worthwhile secondary rationale. The review materials make a good case for consolidation driven by global comparators such as Canada. However, we recommend that this thesis is tested with the UK pensions industry i.e. ***grounded on clear feedback and data from stakeholders in UK schemes*** that allocation to real assets has been hindered by an absence of scale, rather than by other factors.

2. IMPACT OF CONSOLIDATION ON KEY ROLES AND SKILLS

An unavoidable impact of consolidation will be reduced headcount in key pension functions. Focussing on the Investment management (& oversight) function and Trustees, this will however ***present an opportunity to raise the bar on competency and skills in the sector***. A framework that ensures competency, with relevant qualifications and requisite experience for key roles, will be critical, given the much greater investor and market impact of investment processes and decisions post consolidation.

In our September 2023 response to the DWP and HMT's consultation on Trustee skills (link below) we stated the following:

*"…we believe that a board of trustees **should have at least one board member with professional investment experience and an investment qualification**. We would describe this as someone who has an OFQUAL level 6 financial qualification as a minimum, or equivalent experience and skills in investments gained through professional work over many years. This would equip the board to challenge their advisers…"*

- response---september-2023---dwp-on-trustee-skills.pdf

The other point to make in this context is a need to ensure an ***open, transparent, and competency driven process for the recruitment of trustees*** for all schemes. For example, recommendations from trades unions for employee / beneficiary representatives should not be made only due to union membership, or loyalty, but rather on selecting the most suitably qualified beneficiary representatives on the basis of competency including investment knowledge and skills.

3. THE RISKS OF CONSOLIDATION

To make the consolidation initiative a success, we recommend that ***key risks are transparently articulated upfront, so they are effectively managed on an ongoing basis.*** In our view the key risks include:

- **Barrier to competition:** Consolidation into fewer larger schemes and funds may disadvantage new entrants, innovators, and smaller firms. The sector has benefitted from access to boutique and specialist firms and strategies (such as diversified growth funds, alternatives and multi asset credit funds), and a mechanism is required to ***avoid losing innovation and maintaining competition***. For example, segregated mandates and multi- manager setups within large fund vehicles could be potential solutions. An outcome that results in a few large fund houses dominating the asset pool would indicate a failure of the consolidation strategy.

- **Concentration of ideas:** Investment teams managing or overseeing much larger Assets Under Management will inevitably lead to a concentration of investment ideas and decisions***. In addition to the investors, markets could also be impacted*** by decisions that can move asset class / markets. The collapse in the UK government bond market immediately following 2023's mini-budget demonstrated the risks arising from concentration of investment strategies in the same direction.

- **Concentration of operating risk:** The impact of operating risks could be much more widespread than currently, in areas such as cyber security (refer USS data breach in March 2023), trade settlement, potential systems down time and, at the extreme, failure of a scheme. A ***greater emphasis on operational resilience and risk management processes*** will be required.

- **The exercise of stewardship:** With more concentrated funds, their stewardship activities will have much greater influence as their percentage shareholding of companies becomes more significant. Ensuring this ***power is exercised judiciously, driven by interests of scheme beneficiaries***, while also considering wider sustainability impacts, will be key.

- **Risk of external influence:** There is a greater risk of external influence (such as from government itself) being exerted on large pools of assets to achieve other desired outcomes. ***Conflicts of interest management and ensuring independence are therefore critical.*** We also re-emphasise the need to ensure the independence of trustees and Independent Governance Committees (IGCs) post-consolidation. In our October 2024 response to DWP's Value for Money (VfM) consultation (link below), we stressed:

  "with the increased prominence and responsibility of IGC's in the process, we recommend a review of their independence, both structurally and in practice, so that the VfM assessment is grounded in objectivity and investor interest."
  - cfa-uks-letter-in-response-to-fcas-consultation-on-vfm-framework-for-default-dc-pensions-cp24.pdf

4. ATTRACTING INVESTMENT TO THE UK

We note that the review has not proposed a mandatory percentage UK Allocation, albeit there is discussion in the industry and the media for and against such an approach. We ***recommend against requiring a minimum % allocation to UK assets*** as there is no evidence that an externally imposed limit would align with the objective of optimising returns for investors, or with fiduciary duty.

However, we appreciate that in the absence of any requirement, the outcome for UK allocation based on consolidation alone is uncertain. We make two preliminary suggestions below, and would be happy to support further research and analysis on these or similar ideas, if helpful to the initiative:

- **Allocation to private and productive assets**: The review could draw upon economic and capital market research to ***provide evidence based guidance on ballpark allocations in real or productive assets***. The diversification impact and risk - return - liquidity profile of such allocations within a larger multi asset portfolio can be sourced from independent bodies as transparent analysis and information assist investment committees in their decision making. Guidance could also prioritise any surpluses arising in in DB schemes for allocation to less liquid asset classes.

- **Allocation to listed equity**: The US equity market currently accounts for 70-75% of the value of global listed equities, while the UK's share is in the low single digits. Economic theory supports allowing capital to flow towards the best growth opportunities, without "home bias". This arguably facilitates herding in which some investors follow momentum that may lead to asset bubbles. An empirically and theoretically robust solution remains elusive other than that of diversifying across asset classes and markets to avoid excessive concentration in correlated assets (see paper attached below from one of our members Isaac Tabner, 2012, for further discussion).

  Approached from a risk management perspective, concentration levels are presently greater in some sectors and stocks than ever seen before***. Schemes could be encouraged to review their appetite for concentration risk*** and potential mitigating actions such as stock , sector, and/or country caps, in the long term interest of beneficiaries. A reduction in concentration should set the stage for greater allocation flexibility. We caveat however that any cap is an active allocation decision, therefore, when active fund performance deviates from the passive alternative as a result of a cap, the performance deviation needs to be measured, recorded, and accounted for.

  Tabner I 2012 In Defence of Capitalizat

5. ADOPTION OF TECHNOLOGY IN THE PENSIONS SECTOR

A broad pensions review would be remiss in not ***advocating and creating an environment for the rapid and safe adoption of new technologies***. Technology can help modernise the sector post consolidation, and address persistent challenges. We invite reference to a recent CFAI report on AI in pensions (link below), which indicates how technology can help the sector. Two examples are:

- **Low investor engagement:** The majority of pension members do not engage with their pensions and do not understand investments sufficiently. Technology can help through personalization, efficiency, and financial literacy. Tools "…already available include chatbots, robo-advisers, interactive dashboards, automated nudges, and AI-generated account statements". Technology can also support engagement by the provision of accessible and easy to understand benefit modellers. Some large, leading schemes already have client systems that allow then to show the impact of increasing voluntary contributions, changing target retirement dates, and changing the asset allocation of the DC component.

- **Risk management & Investment management**: AI and tech can support the management of key risks associated with pensions, e.g., increased efficiencies in information sharing and analysis could improve pension boards' decision making, including investment strategy decisions. Similarly, actuarial advancements "…driven by advanced Machine Learning techniques could benefit asset/liability management and strategies for pension derisking".

  - Pensions in the Age of Artificial Intelligence

6. PRIVATE SECTOR DB SCHEMES

We agree with your current focus on DC and LGPS Defined Benefit (DB) assets, as these are open pension schemes accruing new pension benefits, and align with the diversification and growth objective, whereas private sector DB schemes are maturing and often being managed to de-risked positions or insurance buyouts. However, there are still over £1tn of assets in private sector DB schemes, as quantified in the PPF's recent Purple Book. The potential for these schemes to target higher returns through productive assets does exist and we suggest some encouragement and guidance on this for private sector DB schemes in the new Pensions Bill.

We also note that buy-out by insurers is itself a form of consolidation. But there are ***several constraints on insurers investing in more productive assets***, including the Solvency II / UK framework, lack of incentive to seek additional returns vs. matching liabilities, and the Pensions Regulator's focus on de-risking. Addressing these issues in an appropriately careful and judicious way will be required to cause any marked shift in the way the £1T of DB assets are invested. It would have an impact both before and after buy-out because DB schemes position their portfolios to be attractive to insurers ahead of any transaction.

We hope our comments are useful and would be grateful for the opportunity to discuss our feedback, and indeed conduct any further analysis that would help with the review.

Yours sincerely,

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With thanks for their contributions to*: Isaac Tabner CFA, Alistair Jones CFA, and the oversight of CFA UK's Ethics & Professionalism Steering Committee.*

APPENDIX I: About CFA UK and CFA Institute

CFA UK serves nearly 12,000 members of the UK investment profession. Many of our members analyse securities, manage investment portfolios, advise on investments, or are in roles responsible for investment operations or oversight.

Our role is to help investment professionals build and maintain their skills and competencies so that they are technically and ethically competent to meet their obligations to clients. We advocate for high standards of ethical and professional behaviour and our work with regulators, policymakers and standard setters is focused on skills, knowledge, and behaviour.

We are not a lobby group or a trade body. We are an independent, professional association whose mission is to 'educate, connect and inspire the investment community to build a sustainable future.'

Founded in 1955, CFA UK is one of the largest member societies of CFA Institute. Most of our members have earned the Chartered Financial Analyst® (CFA®) designation. All our members are required to attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials. The institute is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Its aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

For more information, visit www.cfainstitute.org.