Powerful Pensions

Unlocking Defined Contribution capital for UK tech growth

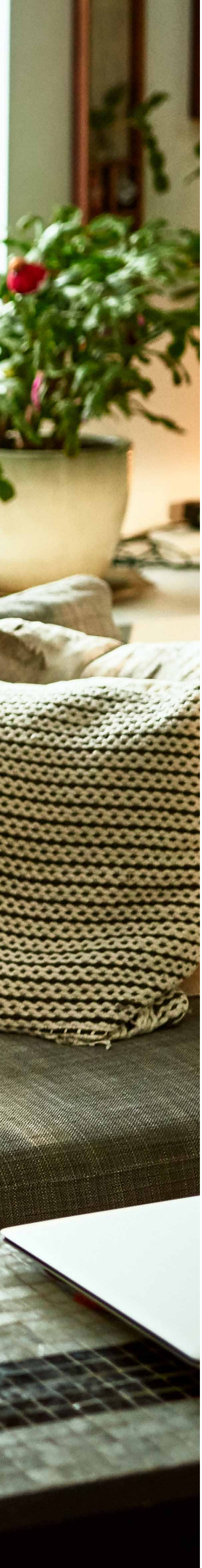
March 2023

EY

Building a better working world

DOMINE DIRIGE NOS

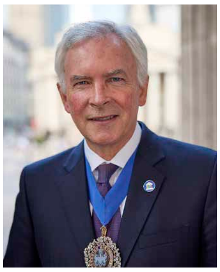
CITY OF LONDON



Contents

Foreword

The City of London Corporation



Nicholas Lyons
The Lord Mayor
of London

As the 694th Lord Mayor of the City of London, I am delighted to be able to present this report on *Powerful Pensions: Unlocking DC capital for UK tech growth*.

The UK is bursting with creativity and enterprise. This is a great place to start a tech business. But what happens as these businesses grow? Far too often, they are snapped up by overseas investors. And when it comes to choosing a place to list, far too often they choose New York or other stock exchanges, rather than London. The seed is sown here, but the reward is reaped overseas. Often, as they begin their scale-up journey, overseas is where they must look for investment, because the deep pools of capital are not here. This starts them on a journey they perhaps, do not actually want to go on.

Solving this problem is central to my theme as Lord Mayor: *Financing Our Future*. As this report shows, part of the answer lies in the UK's pension industry.

Today, I and the City of London Corporation call on industry and our pension funds to collaborate and plug the funding gap faced by our high-growth firms. Strong collective action here could take the form of a Future Growth Fund. Such a fund would enable investment via private equity into fintech, life sciences, biotech, and green technology. By channelling this investment, we can create growth and in turn support jobs and prosperity across the whole UK economy.

Such a Fund, that over time allocates 5% of all pension contributions into it, would give millions of people a modest but meaningful stake, democratising returns, and give everyone a role in creating the UK's most innovative companies of the future.

As this report shows, the money is there. We have the second largest pension fund pot in the world, but UK pension funds invest less in private equity and infrastructure than our competitors.

This is partly due to regulatory barriers, but also due to long-standing structural and cultural issues, with an industry that does not yet have the private market products or suitable investment vehicles, and which is not as confident in the valuation practices and reporting metrics used in private markets. Working together to establish a Future Growth Fund, defined contribution pension funds can share the risk and the benefits.

I very much welcome the Chancellor's promise in the Budget statement to help make this a possibility, with measures to be announced in the Autumn statement to unlock productive investment from defined contribution pension funds. The City of London Corporation will work with government and business to help achieve this.

The City of London Corporation is committed to helping industry convene and create the space to set in motion what they must do to deliver a Future Growth Fund. Now is the time for the industry itself to step up to the plate, to back our high-growth firms and finance our future whilst helping individuals to finance their own futures.

It is time for us to act decisively and take a new approach. Business follows the money. If we want to keep firms here in the UK, we need to make sure they can get the investment here in the UK.

I hope this report will help ensure we can have powerful pensions, driving UK tech growth and seizing the opportunities of the future.

Nicholas Lyons
The Lord Mayor of London

EY

Axe Ali
Partner, Private Equity and Venture Capital, Ernst & Young LLP (EY)

Unlocking the opportunity from defined contribution (DC) pension funds to support high-growth UK companies has huge potential. With an estimated £1t in assets in DC pension funds by 2030, the strategic investment of this capital could be critical not only to the recipient firms, but to the future economic growth of the UK.

The UK is the destination of choice for some of the most impressive high-growth tech firms in the world, yet they currently face a funding gap. Supporting these innovative firms by providing access to new avenues of capital would be a critical move and could have a beneficial ripple effect across the UK economy.

Underpinned by legislative and regulatory directives, a new growth fund could provide the much-needed impetus for change but would need to be followed by market and cultural reform. This will require collaboration between the financial sector, regulators, and high-growth firms.

As a global firm that invests hugely in growth and innovation, EY is proud to have worked with the City of London, the Lord Mayor and Innovate Finance to bring this proposal of a new growth fund to market. We are excited to see how it develops, to support tech firms that would benefit from an injection of much-needed capital to reach their full potential and become part of the UK's tech growth story.

Axe Ali
Partner, UK Private Equity and Venture Capital

Innovate Finance

Janine Hirt
CEO,
Innovate Finance

INNOVATE | FINANCE

Innovate Finance is delighted to be working with the City of London Corporation and the Lord Mayor on this important report prepared by EY on mobilising DC pension funds to invest in Growth Capital.

As the independent industry body for and voice of UK FinTech, Innovate Finance has continually promoted the benefits and attractiveness of investing into FinTech, and highlighted the Growth Capital gap as a critical obstacle to the continued growth of the sector.

In addition, as the co-secretariat for the Kalifa Review, Innovate Finance has reiterated the need to plug this gap in order to see the realisation of the full potential of UK FinTech and drive our international competitiveness.

Most importantly, we must look at the impact this gap – which is prevalent both in FinTech and across the wider UK venture capital market – is having on future generations of consumers. The de-equitisation of UK pension funds over recent decades means that upcoming generations are not maximising their investment returns, which will significantly impact them at retirement. It is essential that we address this now.

Much good work has already been done to progress the issues faced by DC pension funds when considering Growth Capital, and the momentum is clear. Innovate Finance fully supports this initiative by the City of London Corporation and the Lord Mayor to bring this ambition to reality.

Janine Hirt
CEO, Innovate Finance

Executive summary

- The UK is home to some of the most creative and innovative businesses in the world,[1] many of which are within financial, professional services and technology sectors (FPS Tech). However, they often struggle to access growth capital (defined as Series B funding to exit) from domestic institutional investors. This growth funding gap, which some estimate at £1.5t,[2] can hamper their ability to grow domestically and compete globally.
- Currently, just 1% of the £4.6t in pensions and insurance assets is invested in unlisted UK companies.[3] This means that UK savers do not benefit from the returns of these success stories.
- This report explores how the challenges surrounding domestic institutional investment into UK FPS Tech can be addressed to ensure that generations of savers can benefit from backing innovative and high-growth companies.
- It focusses on a specific issue – and indeed opportunity – of unlocking domestic Defined Contribution (DC) pension fund capital to invest into UK FPS Tech companies at the growth stage via venture capital (VC) or private equity (PE).
- This report should be considered as complimentary to the existing work that explores the lack of equity allocations within the overall UK pensions industry,[4] those aimed at broadening DC pension investments generally into illiquid assets[5] and work focussed on supporting FPS Tech start-ups and early-stage companies.

Challenges

- A range of challenges prevent DC pension schemes from investing into FPS Tech and realising the returns offered by these investments. For example, a 22-year-old new entrant to a default DC scheme with a 5% allocation to growth equity could achieve a 7-12% increase in total retirement savings.[6]
- There are both regulatory and non-regulatory challenges, and these challenges are often interlinked, which can make it difficult to determine which factors are most significant.
- Regulatory challenges include:
  - The charge cap on default DC pension funds and inclusion of performance fees within the charge cap.
  - Requirement for trustees to justify and explain investment strategies into illiquid assets.
  - Matching adjustments and Solvency II reforms.
- The UK government is making changes to exclude performance fees from the default DC pension charge cap. However, this may not deliver the impact required given the industry's underlying focus on keeping costs low. Solvency II reforms may also help address some of the regulatory barriers identified but these mainly impact insurers, rather than DC pension funds.
- These regulatory challenges, which are not insurmountable, are mostly related to underlying non-regulatory challenges, including:
  - A lack of private market awareness within DC schemes due to the historical focus on investing in public markets.
  - The influence of trustee and consultant interaction in determining asset allocations.
  - A lack of consumer education and engagement that leads to more than 96% of DC policyholders being in the default option.[7]
  - A lack of suitable investment vehicles in private markets for DC pension schemes.
  - A lack of private market products available on the platforms used by pension schemes and asset managers.
  - Structural issues relating to the small size, scale and fragmented nature of DC pension funds and pots in the UK, which limit the ability to invest into private capital.

- The VC and PE funds available in the UK are not of a suitable scale or size for DC pension schemes, especially when compared to funds in other countries.
- The different reporting metrics used by private and public markets mean that pension funds are less confident dealing with private markets.
- The pension fund industry norm of providing daily liquidity, which can be difficult when dealing with private capital and other illiquid investments.

Actions

- The complexity of the pensions value chain highlights that there is no single solution to the myriad of regulatory and non-regulatory challenges to investing DC pension capital in FPS Tech. Addressing these challenges will require a range of activities, including at an individual organisation level and broader collective action throughout the industry.
- Individual action could include enhancing communications and altering engagement strategies with beneficiaries and underlying pension fund members; establishing best practice reporting and engagement tools; developing corporate venture capital capabilities in the pension industry; and/or creating new fund structures at an individual firm level, which provide pension funds with the ability to invest into FPS Tech. The latter, creating new fund structures, may also require collective action.
- Collective actions include a growth fund specifically for DC pension capital; mandatory or incentivised target investment allocations to private capital across the entire industry; structuring funds for the entire industry that hold FPS Tech and other illiquid assets within default DC funds strategy; consolidation of smaller DC pension schemes; education and awareness building within the industry about the opportunities in FPS Tech investments; and/or changes to reporting and disclosure standards for pension funds, which could help drive engagement with underlying pension fund members.
- Many of the challenges described in this report are structural. Therefore, collective action will be critical to moving the growth agenda forward — and there needs to be a catalyst for this collective action.
- A Future Growth Fund (FGF) is a promising concept for this catalyst. The FGF would be led by the private sector and funded by private DC pension schemes. This approach would enable VC and PE investment into FPS Tech, as well as life sciences, biotech, and green technology. These areas also feature a number of UK-based high-growth companies which present an opportunity for strong returns for pension investors.
- The FGF concept is distinct from that of a sovereign wealth fund, which would be state-owned. Although FGF would initially be funded predominately through DC pension scheme capital, there may also be an opportunity for other holders of capital — both domestic and international — to invest into the fund.
- The FGF is therefore an opportunity to attract further investment into the UK and to grow the overall health of the economy, as well as the businesses supported by the fund. This may be the catalyst that the UK needs to unlock DC pension capital and help FPS Tech grow. It is therefore important for industry, regulators, and government to explore how to progress with this concept.
- Our research has found that consolidation and a collective funding vehicle are key factors to unlocking DC pension capital for FPS Tech investments. These factors are mutually reinforcing. Smaller schemes need to consolidate to participate and, therefore, benefit from investing in a vehicle like the FGF. At the same time, the vehicle itself needs to attract a certain level of investment in order to deploy the capital required for Series B and beyond. Consolidation and a collective funding vehicle can also help de-risk DC pension schemes, increasing their exposure to high-growth companies to allow their members to benefit from the returns.

Introduction

Background and objective of this report

The UK is home to some of the most creative and innovative high-growth businesses in the world, many of which are in the financial, professional services and technology (FPS Tech) sectors.[8] The growth of the FPS Tech sector has been supported by world-leading levels of investment, including £24b in 2022 alone.[9] Despite these significant flows, companies often struggle to access growth-stage capital (defined as Series B funding to exit) from domestic institutional investors, often relying on international investors, largely from North America.[10]

The sector's ability to attract sophisticated international investors is testament to the quality of UK businesses and brings advantages of a globally diversified funding pool. However, the majority of UK Defined Contribution (DC) pension schemes do not invest into private capital, which means their members do not benefit from the sector's growth potential. Firms in the FPS Tech sector also fail to capitalise on the domestic expertise that UK-based professional investors could bring them.

This report explores the range of regulatory and non-regulatory challenges that prevent UK DC pension schemes from investing into FPS Tech. The work is based on a combination of quantitative data analysis and qualitative research interviews with 29 senior stakeholders from the following groups:

- Pension schemes
- Professional trustees and advisors
- Pension benefits consultants
- Asset managers
- VC and PE investors
- UK FPS Tech companies

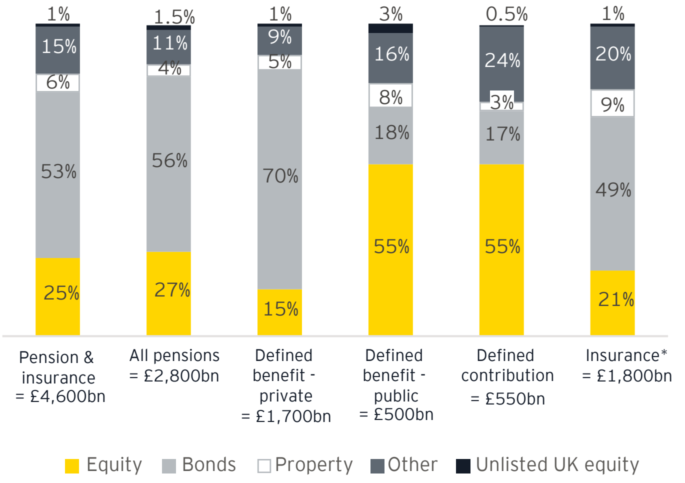
The report builds upon the existing body of work aimed at unlocking DC pension fund capital for investments including the Productive Finance Working Group (PFWG),[11] Productive Finance Roadmap,[12] PFWG guide to investing in illiquid assets,[13] Kalifa Review[14] and Capital Markets Industry Taskforce.[15] This study also builds on financial analysis completed by New Financial on DC pension exposure to equities.[16]

The findings also sit against the backdrop of the UK government policy agenda, including consultation aimed at facilitating DC pension scheme investments into illiquid assets,[17] which has culminated in draft guidance,[18] the Spring Budget 2023,[19] and consultation on Long-term Investments For Technology and Science (LIFTS) initiative.[20] We also note Financial Conduct Authority (FCA) rules for an innovative new category of open-ended authorised funds, the Long Term Asset Fund (LTAF), designed to invest efficiently in long-term, illiquid assets.[21]

The objective of this report is to promote further engagement and act as a catalyst for the collective action required to unlock DC pension scheme capital and support of the growth of FPS Tech in the UK to generate returns for the underlying pension scheme beneficiaries.

> “To develop the next generation of globally competitive companies that grow and list in the UK, and to bolster the retirement incomes of millions of ordinary people, it will be critical to unlock DC pension fund investment into the UK's innovative firms.[22]
>
> UK Spring Budget 2023

Figure 1: Estimated asset allocation of different pools of long-term capital in the UK in 2021



*Insurance asset allocation as of 2020

Source: Report – Unlocking the capital in capital markets – New Financial

Overview of the UK's high-growth FPS Tech opportunity

The UK has been successful in becoming a leading global tech and FinTech hub, with 115 tech unicorns (privately held start-up companies with valuations over $1b)[23] and 41 FinTech unicorns.[24] A recent downturn in the global economic outlook combined with multi-decade high interest rates have impacted the current investment environment. Despite this, investment into UK-based FinTechs only decreased by 8% from 2021 to 2022,[25] and the UK continues to be ranked second globally for FinTech investment ($12.5b across 547 deals) behind the United States, and well ahead of European competitors.[26]

Notwithstanding the impressive funding levels in recent years, many stakeholders argue that high-growth firms still face a funding gap, including 66% of the participants interviewed for this report. The FinTech growth funding gap is estimated to be £2b,[27] whilst the wider growth funding gap for UK scale-ups was estimated to be between £3-6b in 2017[28] and was projected to have reached £5-10b per annum by 2020.[29] According to one estimate, there is a £1.5t growth funding gap that the UK needs to close by 2040 to lift the economy out of stagnation and compete on a global scale with countries like the US.[30]

Untapped opportunity for UK DC pension funds

The majority of DC pension funds do not invest into private capital investments. According to a government survey of UK pension funds, two-thirds of providers reported having zero direct investments in illiquid assets in their default fund(s).[31] About a third had a small proportion, typically between 1.5% to 7.0% as part of a multi-asset structure, with the majority of funds invested into property or infrastructure.[32] More than four-fifths of UK DC pension fund investments are in listed equities and corporate and government bonds.[33]

The context of growth in private markets

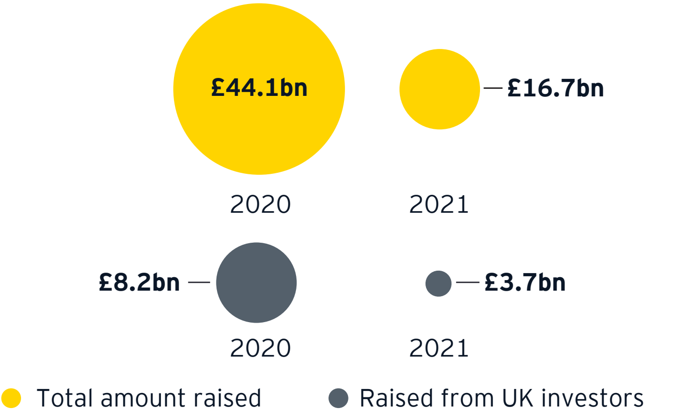
The majority of the FPS sector funding flows sit within a wider context of growing private markets and declining public markets. In the UK and the US, the number of listed companies has declined, with 548 companies delisting between 2017-2022.[34] In 2021, almost 70% ($7.5t value) of the $11t value created globally by start-ups and scale-ups founded in the last 10 years was attributed to private markets.[35] FPS Tech companies have tended to stay private and raise capital from VC and PE, rather than list publicly.

These private company investments have delivered strong returns. Investors, with VC and PE funds with vintages between 1980 and 2017 delivered an internal rate of return (IRR) since inception of 14.9% as of 2021.[36] Overall, private capital returns continue to outperform public markets on a relative basis.[37] More specifically, technology VC and PE funds (those that invest over 60% of their capital into technology companies) have delivered 15.5% IRR for funds created since 2000 and 30.3% IRR for funds created from 2014 onwards.[38]

The role of international investors

The opportunity to generate returns from private markets, especially at the growth stage in UK FPS Tech, has attracted international investors. In 2021, only £3.7b out of a total £16.7b raised by VC and PE funds came from UK investors (22%).[39] The picture is the same on the investment side, the majority of FinTech investment from 2016-2021 came from non-domestic capital.[40]

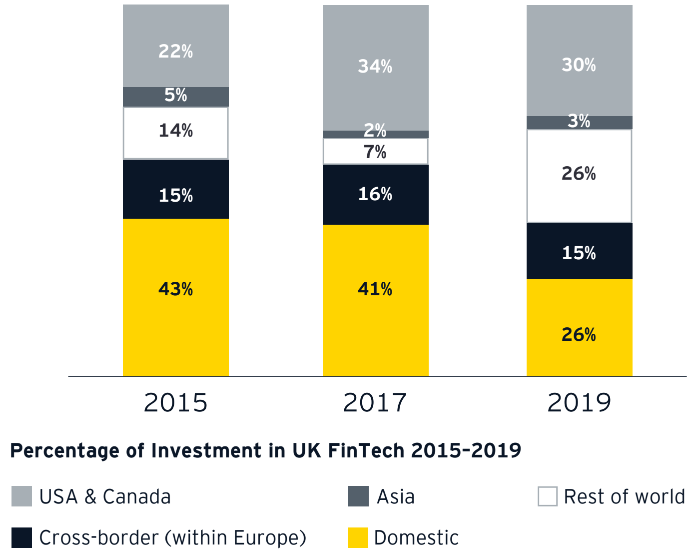
Figure 2: Total PE and VC funds raised in UK 2021 vs. 2020



2021: 16.2% vs. 2020: 36.8%, 2021: £2.7bn vs. 2020: £16.2bn, 2020: 19%

Source: BCVA

Figure 3: Domestic investment accounts for a falling proportion of total UK FinTech investment

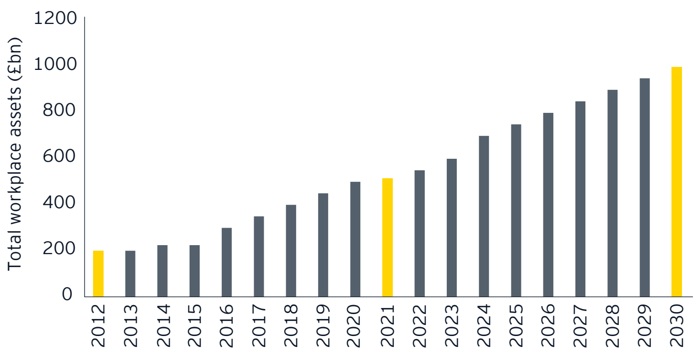


Source: Kalifa Review

The transition from DB to DC pension schemes

The transition in the UK market from Defined Benefit (DB) pension schemes to DC trust-based and contract-based workplace pension schemes has had a significant impact on both the amount of pension assets available for investment as well as the asset allocation of these schemes. Ten years after the launch of automatic enrolment in 2012 there were 18m active savers in UK workplace DC schemes. Over this period, their assets increased from around £200b to more than £500b; they are expected to double to £1t by 2030.[41]

Figure 4: Growth of workplace DC pension schemes' assets



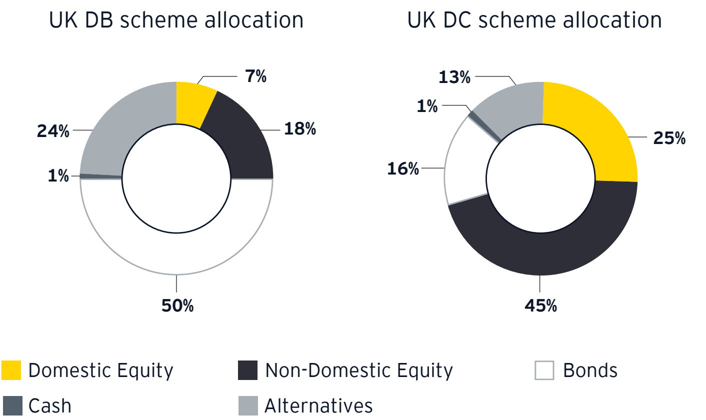
Source: Productive Finance Working Group

Figure 5: Key differences between DC and DB pensions

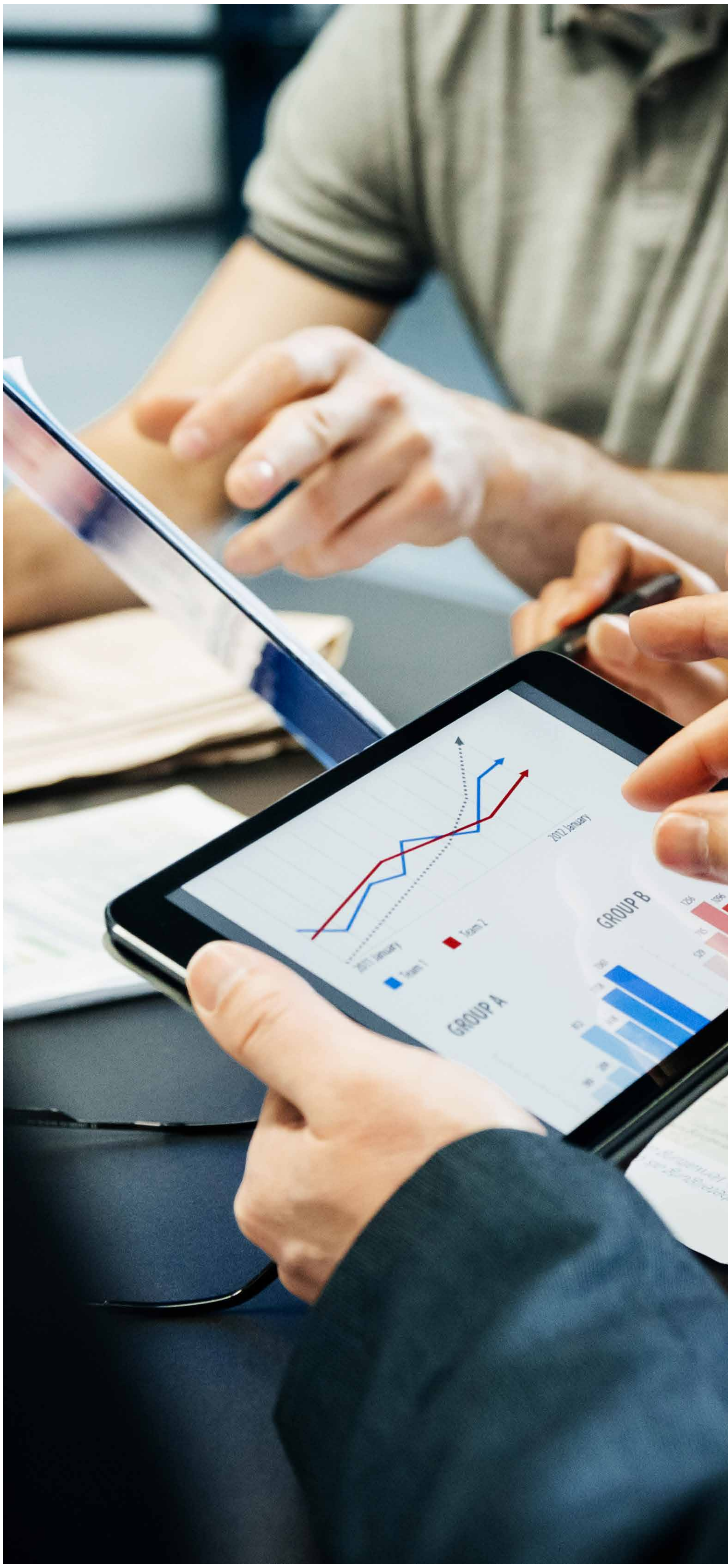
	Defined-contribution plan (DC)	Defined-benefit plan – private (DB)
Investment risk-bearer	Employee	Scheme
Benefit	Unknown/ Unguaranteed	Known/ Guaranteed
Pay-out basis	Plan performance and contribution amount	Fixed formula
Admin costs	Lower	Higher
Portability	Yes	No

In addition to the overall transition from DB to DC pension schemes, it is important to note the shift in asset allocation patterns. DB pension schemes were historically invested into a wider range of assets, including liquid investments and private capital. The average DB scheme allocates roughly a quarter of its investments to liquid and illiquid alternative assets.[42] In contrast, the average DC scheme allocates only 4.6% to illiquid assets, which includes property, PE and/or commodities.[43] This proportion is low compared with the traditional approach of DB schemes.

Figure 6: UK DC schemes allocate significantly less to alternative assets such as VC and PE than UK DB schemes



Source: Source: British Business Bank

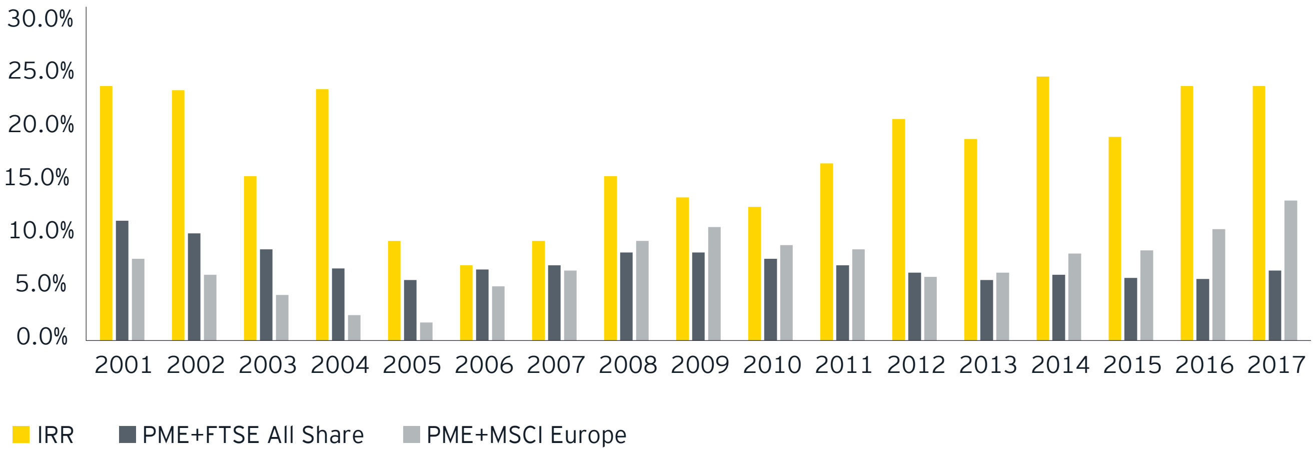


The opportunity to improve DC pension returns

Whilst employers bore the risk of poor investment performance in DB schemes, it is the employees who bear the risk in DC schemes.[44] This difference is particularly relevant as DB pension schemes have historically outperformed DC pension schemes, meaning employees face a higher risk of lower pension savings.[45] In addition, DC pension schemes tend to have lower average assets per membership,[46] which places additional emphasis on a diversified portfolio to drive returns. According to a 2021 survey, 87% of DC pension scheme members are expecting a shortfall in retirement income based on suboptimal allocations.[47]

Private market investments may help boost the confidence of members. Over the past two decades, funds with >15% allocation to private markets achieved a 1.6%-point premium in median annualised returns (8.1% vs. 6.5%) vs. funds allocating only 5% to private markets.[48] The data demonstrates how DC pension funds investing into private markets could help improve retirement outcomes for members. Estimates suggest that a 22-year-old new entrant to a default DC scheme with a 5% allocation to VC or growth equity could achieve a 7-12% increase in total retirement savings.[49] Moreover, allocation to VC and PE could reduce the deficits in younger DC members' pension pots by up to 60%.[50]

Figure 7: Analysis of returns: Since inception capital dynamics IRR and PMR+ by vintage year



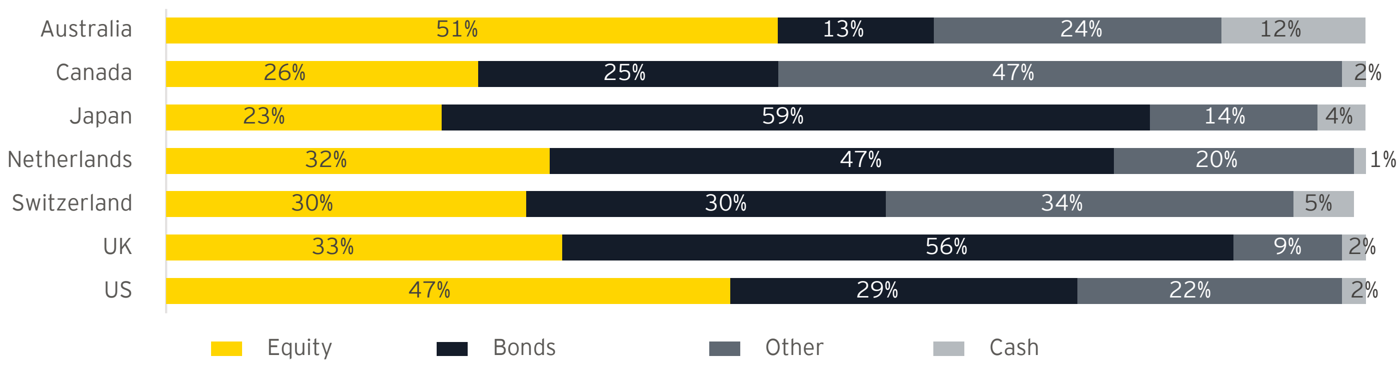
Source: BVCA

International comparisons

In contrast to the UK, North American pension funds have been especially active in VC and PE (especially for FPS Tech companies) for many years. The Ontario Teachers' Pension plan announced in 2022 that it was going to increase its private tech investments from 3% to 7-10% of its total portfolio.[51] Similarly, Australian superannuation funds invest into FPS Tech, both in the UK and other markets. For example, the Hostplus superannuation fund has more than $3b invested into 'innovation and technology' companies and acts as a Limited Partner (LP) in 20 VC funds globally.[52] These funds also operate with higher fees, which gives the investment managers greater flexibility to invest in private markets and other illiquid assets. For example, the average fee for Australian super DC schemes is 112bps and the largest scheme's average fee is 84bps.[53]

> "You can see with rounds of £100m or more in the UK, they're very rarely led by investors from the UK or Europe. There just isn't domestic capital available to scale these companies. And that's important because where the money comes from ultimately determines where governance and control is based.[54]
>
> Sam Gyimah, Lakestar venture partner and former UK government minister for science, innovation, and higher education

Figure 8: Pension fund asset allocation by country (combined DB/DC) in 2022



Source: Thinking Ahead Institute

Key challenges

Overview

During our research, senior members of the pensions and asset management industries highlighted several causes of the growth capital funding gap and various challenges preventing institutional investors from allocating more to high-growth illiquid assets, including VC and PE. Whilst the challenges are categorised into regulatory and non-regulatory groups, it should be noted that these types are often interlinked.

Due to these interdependencies, it is difficult to determine which group of factors has the most significant impact, and interviews highlighted that there was no strong consensus. The majority of interviewees recognised cultural issues around scheme member engagement and the need for increased education on private capital across the pensions value chain. Additionally, they cited a UK regulatory policy environment as not being conducive to investment into private capital.

Regulatory challenges

1. Charge cap and performance fees

The pension fee charge cap and the inclusion of performance fees within the charge cap was frequently mentioned by interviewees as having an impact on their ability to allocate to private capital. Introduced in April 2015, the pension fee charge cap aims to protect those auto-enrolled into default schemes from high or unfair charges by capping annual charges at 0.75% of funds under management.[55] Since its inception, over 10m pension scheme members in default arrangements have benefitted from the protection against inappropriate charges.[56]

Research has shown that the pensions and asset management industries have viewed the charge cap as a challenge to investing in VC and PE, which due to their higher fees, risk pushing schemes above the charge cap.[57] Typically, VC and PE firms charge management fees of 1.25% to 2% of committed capital as well as administrative fees and carried interest, which typically equate to 15% to 20% of the fund's net profit, but can be as high as 30% for some funds.[58] However, the issue is more complicated than a concern over breaching the charge cap.

> The fee cap is a red herring. No master trust is operating anywhere near the fee cap. It's a race to the bottom on fees.

Our research found that the charge cap has caused a 'race to the bottom' on fees, as the average fees charged by auto-enrolment schemes are between 0.38% and 0.54% of funds under management,[59] a sharp reduction from an average of 0.84% in 2016. For many schemes, a small allocation to private capital would be unlikely to exceed the charge cap.

The implication is that regulation is not the only cause of concern amongst DC pension funds when considering investing into VC and PE; the cultural focus on low fees plays a critical role.

The exclusion of performance fees from the regulatory charge cap could allow investors to provide a wider range of assets to savers within their default strategy. However, interviews with senior stakeholders from the pensions and asset management industries suggest that these changes are unlikely to have a significant impact on the percentage of pension fund assets allocated to FPS Tech. Nearly all of those interviewed said that regulatory change needs to be accompanied by cultural change.

> Trustees need to learn to accept the 2% fees in the typical [private capital] structure. This can still be high for trustees pushing for the lowest fees: If you're doing business at 10bps, having even 5% allocated to VC increases fees to 35bps, which is a cultural problem.

2. Regulatory requirement for trustees to justify and explain investment strategies for illiquid assets

Under the 2023 disclose and explain asset allocation regulations, trustees or managers of relevant occupational pension schemes will be required to disclose the percentage of assets allocated to specific classes in the default arrangement.[60] In this sense, 'default arrangement' refers to circumstances where saver contributions are placed without the member having expressed a choice as to where contributions are allocated or in which 80% or more of members have actively chosen to invest. These regulations apply to most DC pension schemes, given that 96% of savers don't choose their allocations and so are placed into default investment strategies for their pensions.[61]

Proposed changes to the regulations requiring the highest level of granularity in asset allocation disclosures are only currently in draft form. Therefore, the industry will likely take a 'wait and see' approach to determining how these regulations will have an impact.

Our research highlighted a potential skills and expertise gap around private markets for pension fund trustees, given their historic focus on other asset classes.

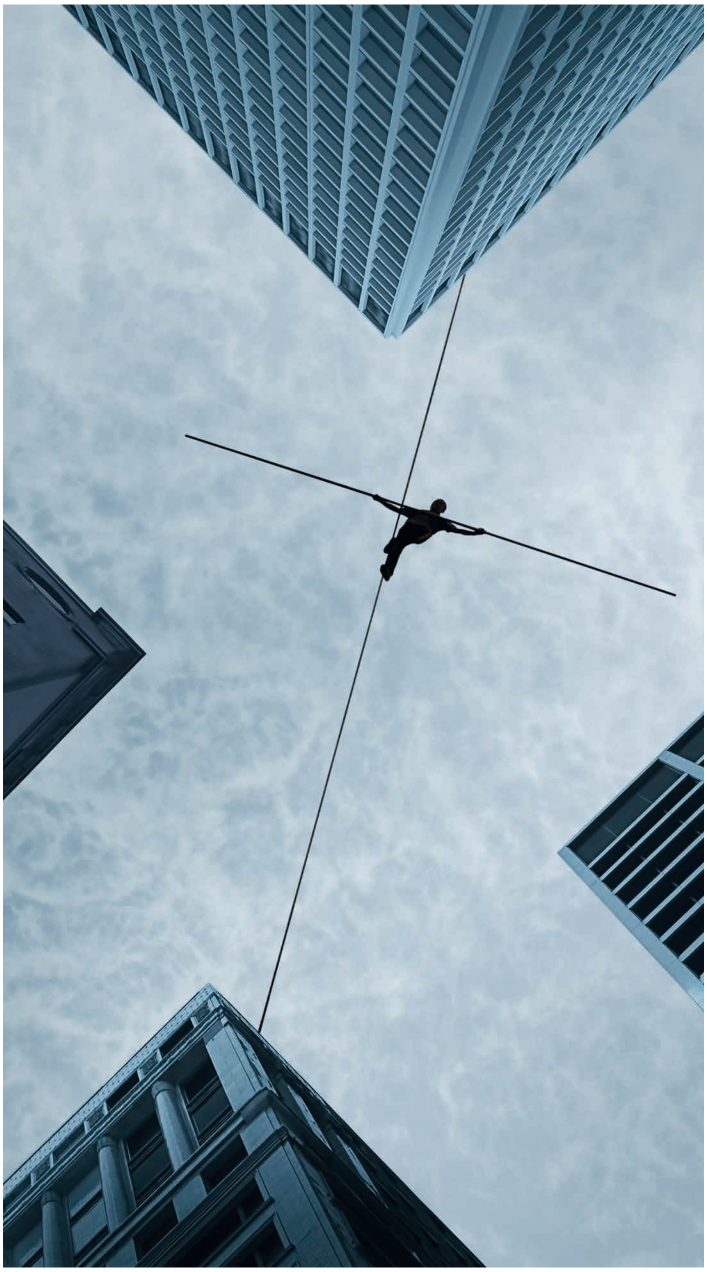
> The private markets didn't necessarily exist in a big way in their [trustees] lifetimes. We do education all the time for trustees on this investing in private markets.

Specifically, we found that trustees' limited experience with private markets potentially creates a reluctance to select such investments despite evidence of these assets' historical returns, due to potential conflicts with their duties under the prudent-person rule. This restricts the choices of financial managers to the types of investments a person seeking reasonable income (and the preservation of their capital) might buy for their own portfolio. It also creates the expectation that trustees should only use their existing, relevant skills and experience to select investments. Increased training and awareness of private markets could help trustees gain confidence that they satisfy the prudent-person rule when considering private capital investment strategies. As trustees often rely on advisors and consultants, these groups are well placed to facilitate such training and awareness, in conjunction with the VC and PE industry.

> If you removed all the regulatory barriers, would trustees pile in on scale-ups? Maybe not … they're pretty cautious people.

3. Matching adjustments and Solvency II reforms

Solvency II regulations currently set out the capital that insurers and reinsurers are required to hold against the different asset classes in which they invest. In effect, it creates a requirement to hold additional liquidity and may therefore be a deterrent for insurance firms to invest in private capital asset classes.



As part of a push to unlock more institutional capital investment into private markets, the UK government has proposed reforms to the Solvency II Matching Adjustment provisions that will broaden the asset and liability eligibility criteria. These proposed reforms relate to when pension schemes buy-out and transition to insurers and therefore do not apply to most DC pension schemes. Because they will not solve the challenge of unlocking DC pension fund money to invest in FPS Tech, we considered them out of scope for this research.

Non-regulatory challenges

1. A lack of private market awareness within DC schemes due to the historical focus on investing in public markets

Traditionally, DC pension funds and other participants within the industry have allocated their DC portfolios primarily towards public markets and their associated instruments, including equities and bonds.[62] Alongside their familiarity, such investments offer advantages for DC scheme trustees; the low cost enables trustees to more easily satisfy their fiduciary duties to act in the best interests of their scheme members.[63]

The commencement of auto-enrolment in 2012 introduced a whole new set of employers to workplace pensions. Employers who did not previously provide a workplace pension were required to select a scheme, and price sensitivity played a significant role in their decision. These employers gave rise to a multitude of DC pension schemes, offering lower administration costs and an opportunity for employers to shift the responsibility of retirement incomes to employees themselves.

Over the following decade amidst market consolidation, employers have periodically reviewed their choice of scheme. This has resulted in a competitive tender process where price became the primary commercial focus for companies that had not previously provided their own DC pension schemes. For larger companies, which already operated their own DC schemes or used contract-based plans, whilst consideration would be made to a broader range of factors, cost remained a key aspect. This backdrop has manifested in a strong focus on cost seen in today's market.

“

The creation of DC schemes has blurred best interest for members with cheapest.

Our research highlights that the focus on cost can be particularly pronounced when the primary decision makers are those without investment experience, for example, corporate HR. The general lack of awareness of non-professional trustees and members regarding private market asset classes was highlighted as a significant challenge to investment in this research.

“

Awareness, education, and interest are needed… or else nothing is going to happen. All other barriers are surmountable.

Other financial services sectors, like banking, have embarked on developing capabilities related to increasing their understanding of high-growth businesses. This includes the development of corporate venture capital (CVC) initiatives to focus on investment and foster a culture of innovation. However, this has not been as prevalent in the pensions industry and represents an opportunity to increase awareness.

2. The influence of trustee and consultant interaction in determining asset allocations

In the UK pensions market, trustees are required to take investment advice from a benefits consultant, who can significantly influence where institutional capital is directed.

The consultants we interviewed noted their current recommended allocations to illiquid and productive assets are focussed on property and infrastructure. They don’t typically recommend non-traditional and lesser-known asset classes, such as FPS Tech, due to a lack of trustee appetite to buy such a product. Conversely, we interviewed multiple trustees who noted that investment consultants’ careers often begin in actuarial roles and, therefore, they have limited experience with private assets such as FPS Tech. This creates a circular scenario. The requirement for consultants to play a leading and effective role regarding investments into private markets and illiquid assets was a recommendation made by the Productive Finance Working Group.

3. Lack of DC policyholder engagement, which leads to the majority in the default option

All interview participants recognised that most UK citizens do not engage with their pensions. In a recent MAPS survey, only 45% of people aged 18-64 said they knew enough about pensions to make decisions for retirement.[64]

Pension funds have a critical role in ensuring that members are actively engaged in understanding how, where, and why their pension pots are allocated. This creates a level of ownership and empowerment, which is necessary to unlock growth investment opportunities, particularly amongst younger cohorts.[65]

“

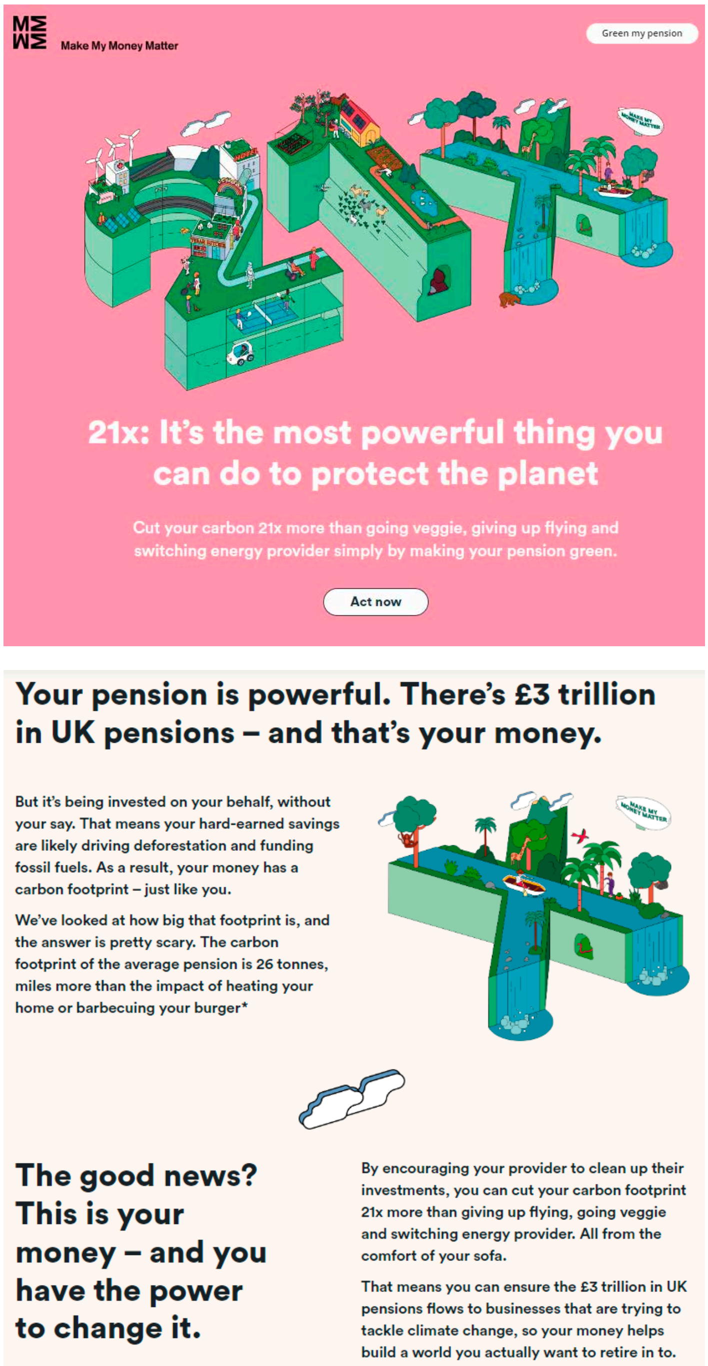
Whilst auto-enrolment has helped people save without having to think about it, such automation has been at the expense of empowering people to make financial decisions that can unlock investment for innovative domestic businesses.

Our research found that ESG and impact investing are potential enablers for increased engagement with savers. Many see these concepts as the gateway to engaging younger members who are more interested in investing than previous generations.[66] According to Royal Mint, 80% of those aged between 15-25 are investing in their futures, with the majority (57%) saving or investing up to £200 per month.[67]

A 2021 Quietroom campaign asked members of the public if they knew where their pensions were invested; the majority said they did not know and 9 out of 10 thought they had no say in where their pension money was invested. However, the majority also said they would save more if they knew their money was doing good.[68] Therefore, finding a way to engage members around the impact of their investments can increase engagement with their pensions. Investments into FPS Tech can align well with social and environmental goals, with many FinTech businesses aiming to improve financial inclusion, reduce carbon emissions and transition to green or circular economies.

Improvements to pension dashboards, statements and the utilisation of other communication channels, e.g., websites, blogs and social media will play a key role in improving engagement, especially as the majority of pension schemes do not communicate with members via social media channels.

The Make My Money Matter campaign is an example of member engagement that sought to educate savers on the potential negative environmental impact caused by many investments made on their behalf and their ability to affect change by engaging with their pensions and switching investment strategies. The 21x campaign likewise shows savers how switching their pension to an ESG strategy could cut their carbon footprint 21x more than going vegetarian, giving up flying or switching their energy supplier



Source: Green my pension – Make My Money Matter

4. Availability of suitable investment vehicles

To date, close-ended funds and venture capital trusts (VCTs) have been used to access fewer liquid assets and aligns with the trend of companies remaining private for longer. There is a need to increase the range of vehicles for investing into private markets. One such option is open-ended, FCA-authorised vehicles, such as the LTAF.

> “This norm is especially unhelpful in an environment where companies need/want to remain private for longer and VCs become forced sellers. One possible solution would be to make it easier for limited life funds to roll over to different funds.

The LTAF is an open-ended, FCA-authorised fund, designed to complement other investment vehicles and offers exposure to less liquid asset classes (e.g., close-ended funds, limited partnerships, offshore professional open-ended funds). LTAFs must invest primarily (no less than 50% of their assets) in long-term, less liquid assets such as VC and PE, private credit, real estate, and infrastructure.

At the time of writing, only one LTAF has been created since the FCA finalised the new regulatory regime enabling their creation in October 2021. Schroders announced the launch of its LTAF structure on March 9th, 2023.[69]

Our research largely took place prior to the Schroders' announcement, and interviewees were attuned to the lack of LTAFs in the market. There is a need for greater clarity on whether LTAFs could be used or are suitable for investment into growth-stage businesses within the FPS Tech sector. With the FCA's discussion on improving the regime for UK asset management open until 22 May 2023, pension fund and asset managers should maximise the opportunity to request more clarity regarding LTAFs.

The UK government also published a consultation on the LIFTS initiative in March 2023.[70] The LIFTS initiative aims to establish new investment vehicles to crowd-in investment from institutional investors, particularly DC pension funds, to innovative FPS Tech and science companies. Under the initiative, the government will make an initial commitment of up to £250m to provide financial support to new investment vehicles or approaches, as well as non-financial support like information-sharing with British Patient Capital.

5. Limited product availability on platforms used by the pension schemes and asset managers

In addition to a lack of appropriate fund vehicles, the insurance platforms used by the pension funds are currently unable to fully accommodate investment into illiquid assets. The PFWG has called for platforms to add more investment choices, since these are real barriers. Our interviews also highlight this is potentially related to costs and overheads. The PFWG found that some platforms would need to upgrade systems and processes to accommodate these investments. Therefore, platform operators should be encouraged to do so across all product types and fund structures.

Certain pension schemes, including NEST, have their own investment management capability and are not on any platforms. This allows for different investment structures and the opportunity to price more effectively.

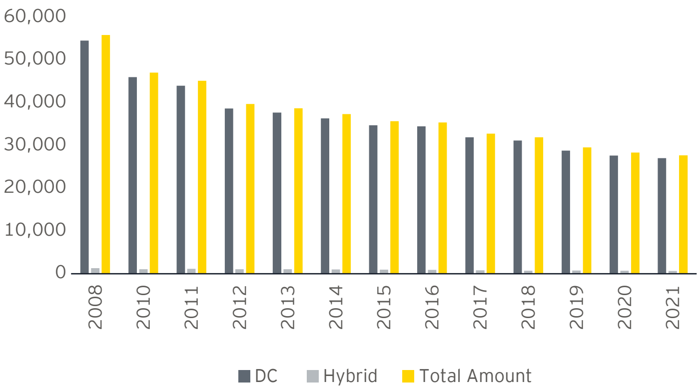
6. Structural issues relating to the size and scale of DC pension funds and pots

The introduction of automatic enrolment in 2012 created hundreds of thousands of new pension memberships and led to a growth in the number of DC pension schemes.[71] This has resulted in the DC market consisting of a long tail of small schemes that do not have the scale of assets under management (AUM) to invest in private capital.

Furthermore, the large number of inactive pots, which increases due to the frequency of job changes by savers, is another structural issue preventing investment into private markets. Trustees are under a duty to treat active and inactive members (for example, those no longer contributing to the scheme due to job changes) equally. According to one interviewee, this may discourage trustees from pursuing investment strategies perceived as more complex and costly as they are unable to focus on providing these to active members only and the smaller size of inactive pots may not be worth the effort involved.

However, during 2021, average assets per member increased by 20%, compared to 10% the previous year (2020) indicating that the tide is beginning to turn.[72] This trend is largely attributed to the government push towards consolidating small schemes into master trusts to gain the scale and expertise necessary to meet a higher standard of governance. According to data from the Pensions Regulator, the DC pension market has consolidated by nearly 39% since the introduction of auto enrolment. As of January 2023, there are now 36 authorised master trusts, accounting for 20.7m DC memberships.[73]

Figure 9: Consolidation of DC pension market 2009-2022



Source: The Pensions Regulator

In September 2020, the government consultation "Improving outcomes for members of defined contribution schemes" set out that the rate of consolidation (8-10%) was slower than needed to improve member outcomes across three dimensions; governance, charges, and investments.[74]

The level of consolidation will result in a small cohort of master trusts which will evolve as the dominant players and define the future of DC investing.[75] Just as schemes raced to snap up new members following the introduction of automatic enrolment, so are master trusts now racing to snap up smaller schemes, with low fees remaining the primary competitive force.

> The market is still in flux and the race to become one of the remaining master trusts providers is fierce. The market is highly competitive, like nothing I have ever seen. It's a bit like the wild west out there, everyone is competing on costs, which is almost seen as a commodity.[76]

Maria Nazarova-Doyle, head of pension investments at Scottish Widows.

Addressing the scale issue is a key component to unlocking DC capital as further consolidation will eventually create a steady state of operators and the focus will be on delivering performance and results. Master trusts will need to have the propositions in place and level of sophistication to deliver as corporate buyers will increasingly demand more.

> It will be akin to a service provider telling you your subscription is going up £1 a month; you're not going to move provider if the cost change is commensurate with the quality of the product.

7. Availability of large-scale, UK-based VC and PE funds

The smaller size of UK VC and PE funds compared with international peers was cited as a challenge to increased allocation into private markets pension funds. The average AUM of the top 10 US venture investors was on average 1351% higher than the average AUM of the top 10 UK venture investors.[77] For PE, the average AUM of the 10 largest US investment investors is 94% higher than the UK sample.[78]

The smaller size of UK funds naturally creates a focus on the early stage, where investments are smaller and investors are able to back more companies with the funds they have raised from limited partners (LPs).

> Smaller UK funds focus their investment activities predominantly in early-stage funding rounds and are often unable to provide follow-on investment at later stages. This requires fund sizes to be over £200m. More experienced venture firms should aim to raise over £350m.[79]

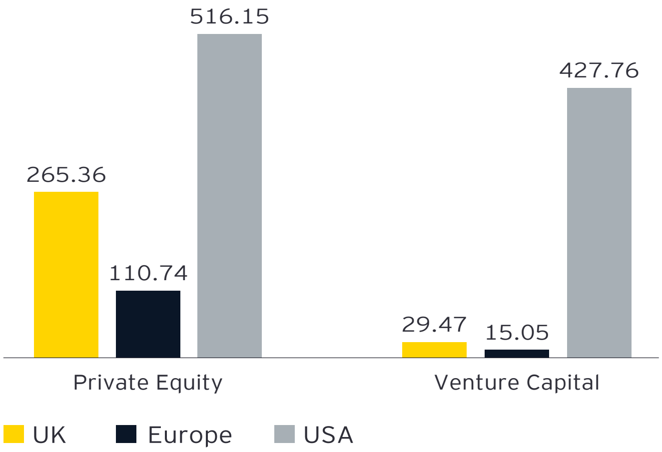
Interviewees highlighted potential concerns with limited talented individuals experienced in investing into high-growth companies, and the importance of track records, with institutional LPs needing to see clear evidence of past performance.

> There are not a fantastic amount of very good VC scale-up people. Many good VC funds have waiting lists, people who are good are in massive demand. There definitely is a capacity problem.

These challenges are circular as growth funds struggle to attract institutional capital and so are limited in number and size, resulting in a lack of suitable funds for institutional investors seeking investment opportunities in high-growth companies.

A potential solution to these issues could be the development of a new growth fund, with critical mass and a highly experienced investment and fund management team with a proven track record. A fund of funds could help address different ticket sizes and help trustees get more comfortable with private markets by providing diversified assets and spreading risk.

Figure 10: Analysis of average AUM by geography ($m), VC and PE



Source: Pitchbook

8. Differences in reporting metrics for public and private markets

The reporting metrics that apply within private markets differ from those used in public markets. These differences can make it difficult for institutional investors like DC pension funds to benchmark performance when evaluating and selecting funds. Given institutional investors are less familiar with the metrics used by private markets, they are likely to be less confident in the performance of the underlying portfolio companies.

In 2007, the BVCA and a group of major PE firms asked Sir David Walker to undertake an independent review of the adequacy of disclosures and transparency in PE. The resulting Walker Review set out guidance on enhanced reporting by portfolio companies, communication by PE firms and recommendations for the BVCA.[80] Given increased stakeholder interest in PE, the private equity reporting group (PERG) and the BVCA began updating the guidelines in 2022, a process which will continue throughout 2023 and into 2024.[81] There are currently 73 portfolio companies and 64 PE firms in scope.[82] The PERG also commissions EY annually to collect data from portfolio companies to illustrate their performance under PE stewardship; the 2023 report is the 15th annual edition.[83]

Participants in the City of London Corporation's January 2023 roundtable on unlocking DC pension capital into FPS Tech outlined how funds focus on overall financial reporting metrics and provide minimal information on the underlying companies they are invested in and their wider impact on, for example, financial inclusion or the transition to net zero. They suggested that the inclusion of additional data on the portfolio companies would increase the confidence of trustees to accept higher risk and fees as they would recognise the potential real-world benefit their investments would generate for members, beyond financial returns. Thereby allowing trustees to acutely demonstrate their fiduciary duty. Improving how VC and PE funds market themselves to pension schemes both at a VC and PE level and at a wider pension fund level by using real-world context was also a recurring theme in our research.

Whilst the work being undertaken by the BVCA and PERG is ongoing, progress is clearly being made to increase the transparency of private markets. These are encouraging steps towards closing the reporting gap with public markets. There remains ample room for improvement, however, in the extent and quality of data that PE firms provide. Improvements in this area would increase institutional investor confidence.

9. The industry norm of providing daily liquidity to beneficiaries

Historically, it has been difficult for investment platforms to hold private assets due to daily dealing requirements. Daily dealing refers to the ability of investors to move in and out of a fund on any given trading day. For DC schemes, there is a single fund price at which buy and sell transactions take place. That price is related to the underlying assets held by the fund, which in most cases can be valued on a daily basis.

In contrast, the illiquid nature of private markets means valuations cannot be updated daily as assets cannot be bought and sold as quickly.[84] Typically, private market funds value portfolio companies on a quarterly basis.

Our research found differences of opinion on how fundamental a challenge daily dealing poses. There is no regulatory or legal requirement for DC pension schemes to offer daily liquidity to their beneficiaries, however a nominal value based on a monthly report would suffice. The role of platforms and the blending of illiquid assets to manage limited quantum of liquidity was considered achievable, however platforms had not invested in undertaking the changes required.

According to the Investment Association, daily priced funds can provide access to less liquid assets, provided appropriate liquidity management tools are in place and investors receive clear communications. For the purposes of generating a daily price of the fund, it should be sufficient to use the latest valuation of any illiquid components.[85]

> “
>
> If you're under the age of 40, liquidity isn't an issue, and these are the people with the longest time horizon, so they are perfectly aligned to private market investment.

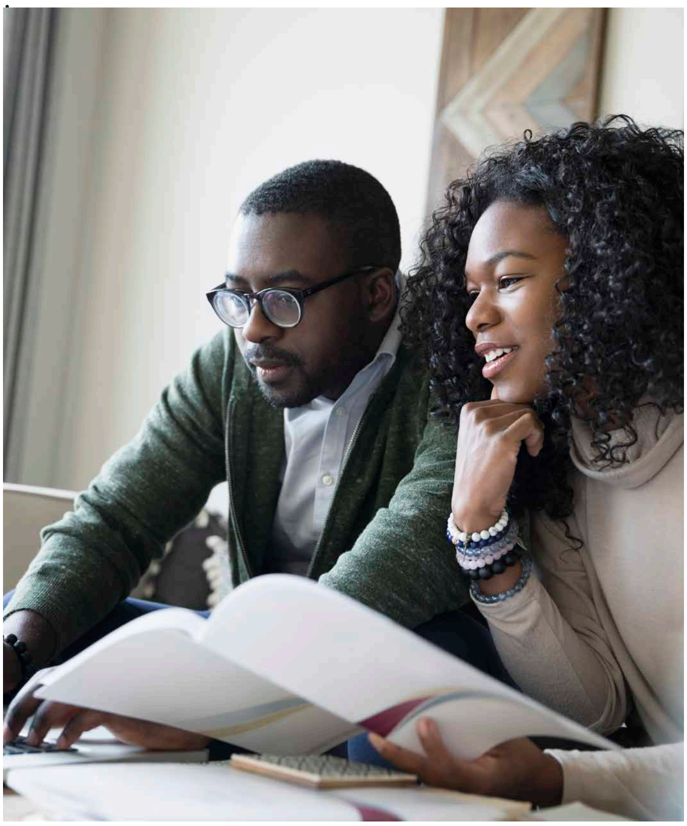
There can be circumstances, whilst rare, that force pension schemes to maintain the liquidity necessary to sell holdings at short notice. These largely relate to a sudden stop of inflows (e.g., mass redundancy at scheme level, government pauses to auto-enrolment, a provider pulling back from the market). If there was a delay in providing this liquidity, funds might have to be provided from the insurer's balance sheet, which comes at a cost to the insurer. Insurers' automated trading operations have been built to facilitate the promised daily liquidity. The manager of a large growth fund highlighted that, whilst daily dealing is not a regulatory requirement, it is a structural barrier to investment underestimated by some industry participants, at least until schemes have the scale of capital inflow to manage minimum liquidity needs.

To date, there has been little commercial incentive for providers to develop alternative structures for access to illiquid asset classes due to limited demand, the resulting lack of regulatory attention and a primary focus on costs.[86] The recently announced LTAF regime, although more focussed on enabling infrastructure investment, seeks to bridge the gap between closed-end drawdown structures and fully open-ended, daily dealing funds. It offers a framework that compromises between the two whilst allowing for a range of liquidity options,[87] which could also be applicable to FPS Tech and other illiquid assets.

The PFWG recommended that LTAFs value assets quarterly but provide investors with indicative prices on a monthly basis, to take into consideration any material changes in the valuation of underlying assets. The FCA's latest guidelines state,[88] **"we do not consider that it would be too onerous for the manager to produce an updated indicative valuation based on known developments in the portfolio. This should give investors confidence in the valuation of the LTAF. Equally, we do not consider that it would be appropriate to require more frequent valuation."** However, private market funds have argued that in many cases monthly valuations would add to management costs without offering commensurate benefits for investors, as the assets will likely have extremely long investment timelines before their value is fully realised.

Furthermore, whilst LTAFs represent a positive regulatory development, finding suitable investments for DC savers remains a challenge as the design of platforms is not a natural fit with the operating model of private market funds. Some DC pension scheme representatives of the PFWG still see the LTAF-proposed monthly valuations as too infrequent and questioned the feasibility of valuing long-term illiquid assets regularly enough to reconcile with platforms' daily dealing requirements.

With the first LTAFs pegged for early 2023, our research findings indicate an urgent need for the government to lay out a clear policy direction providing guidance for DC trustees and insurance firms on how to effectively manage liquidity. Such guidance is critical as trustees and insurers currently perceive liquidity management to be an insurmountable challenge to investing in private assets such as FPS Tech.



Unlocking DC pension fund capital

Overview

The pensions value chain is complex, from the diversity of fund types to the differing size and scale of funds, as well as the various operators involved at each stage. Therefore, a multi-faceted approach is required, including activities at an individual organisation level and broader collective action across the industry to increase DC pension fund investment into FPS Tech companies.

Figure 11: Mapping of non-regulatory challenges and ways to address these

	1. A lack of private market awareness within DC schemes	2. The influence of trustee and consultant interaction	3. Lack of DC policyholder engagement	4. Availability of suitable investment vehicles	5. Limited product availability on platforms	6. Structural issues relating to the size and scale of DC pensions	7. Availability of large-scale, UK-based VC and PE funds	8. Differences in reporting metrics for public and private markets	9. The industry norm of providing daily liquidity to beneficiaries
Individual action									
Enhancing communications and engagement strategies with underlying pension fund members	●	●	●						
Establish best practice reporting and engagement tools.	●	●						●	
Develop Corporate Venture Capital (CVC) capabilities in pension industry	●	●		●				●	
New fund structures, which provide pension funds with ability to invest into FPS tech				●	●			●	●
Collective action									
UK Growth Fund	●	●	●	●	●	●	●	●	●
Mandatory or target investment allocations to private capital across the whole industry	●	●							
Structure funds that hold FPS tech and other illiquid assets within a default strategy	●	●	●						●
Consolidation of smaller DC pension schemes						●			
Education and awareness building with industry	●	●	●						
Changes to reporting and disclosure standards for pension funds to drive engagement with underlying members			●						

Individual action

Enhancing communications and altering engagement strategies with beneficiaries and pension fund members

To improve engagement with pension fund members, DC pension schemes and insurance companies could enhance the frequency, timeliness, and relevance of their communications. Content could address concepts such as value for money and investment returns, rather than simply reporting on costs. Communications could also describe how various investments support member outcomes.

Targeted communications which highlight the FPS Tech companies invested in on behalf of a member may address the apathy and lack of understanding many individuals have about their pensions. This may lead to more individuals making informed decisions about their investments and creating increased interest in alternative assets which may boost returns, such as FPS Tech investments. From October 2022, trustees or managers of DC schemes that provide money purchase benefits only and that are used for automatic enrolment are required to make their statements no longer than one double-sided sheet of size A4 paper.[89] Therefore, whilst trustees and managers should focus on making these shorter statements more engaging, focus should be on communicating with members outside of their statements, perhaps via different communication channels (e.g., social media posts, blogs). The UK pensions regulator also encourages pension funds to consider more innovative ways of prompting members to think about their pension savings.[90]

Examples of effective communication practices

The Association of Superannuation Funds of Australia provides quarterly updates on the market, which include the breakdown of asset allocation and returns.[91] There are websites that provide comparison tools and explain key concepts to non-technical audiences.[92] All individual Australian superannuation funds have their own blogs and social media accounts, where they communicate directly with members and share helpful information on investment returns for non-technical audience.[93] They also publish blog posts on how funds are invested and the impact of these investments from a societal and environmental viewpoint. For example, one blog explains how members are not only investing in some of the world's top brands, buildings, hospitals and roads but also in driverless cars and Australia's coolest technology company.[94]

Some pension schemes in the UK take a different communication style and approach. For example, NEST and Cushion offer helpful communication guides and tools for pension funds to communicate with their employees across a range of messages and media.[95] The pensions regulator even cites NEST's golden rules of communication in its guidance on communication with employees.[96]

Establishing best practice reporting and engagement tools

Interviewees mentioned the lack of a centralised system and inconsistent standards for the type and frequency of reporting on the portfolio companies of funds as concerns. Unlike publicly listed companies, private organisations do not report financial data into a central organisation, such as the London Stock Exchange. The initiatives being progressed by the capital markets industry taskforce (CMIT) on intermittent trading venues (ITV), which is aimed at creating a new type of wholesale market to align public and private markets, would be a potential solution to addressing these concerns.

Pension funds and asset managers should also consider harnessing technology that would allow them to access fund or portfolio company data directly from the source, as well as aggregation and forecasting tools specifically designed for private market investments.

Developing corporate venture capital capabilities in the pension industry

The creation of CVC capabilities within the pension industry would help create more knowledge of private markets and upskill pension fund managers. This would follow a growing trend within financial services and insurance, which has over 110 CVC investors in the UK alone (43 of which invest in FPS Tech).[97] Investment by UK CVC funds peaked in 2021, with the total amount invested reaching $3.18b.[98]

Typically, CVC funds invest strategically, choosing investments that will help expose their business to relevant future trends. Funds often pursue partnerships and joint ventures with portfolio companies to realise these benefits, combining the innovative technology and dynamic attitudes of start-ups with the customer knowledge and financial power of incumbent institutions. Another key benefit of in-house CVC activity is the exposure of staff to different ways of working and innovative thinking.

Creating new fund structures for pension funds to invest into FPS Tech

One of the key supply-side challenges is the limited availability of suitable fund structures for pension funds to invest into FPS Tech. Whilst LTAFs were designed to address the issues regarding daily dealing norms for illiquid assets, it's not yet clear whether those that come to market will be suitable for FPS Tech.

The government and regulator should provide more guidance on the process for creating and authorising an LTAF. Specific guidance on whether and how these funds can be used to facilitate equity investments into FPS Tech and other high-growth, less-liquid sectors would be particularly useful.

If LTAFs do not prove to be a suitable vehicle or fund structure for investments into FPS Tech, an alternative, non-daily dealing fund specifically for FPS Tech should be authorised. The UK government consultation on the LIFTS initiative is a good opportunity for industry to put forward proposals for such vehicles.[99]

Example of innovative approaches to illiquid assets

Partners Group is pioneering an approach to pricing illiquid assets on a daily basis. The newly launched Generation Fund is DC-friendly, offering daily pricing and the opportunity for DC members to invest in a wide range of asset classes, offering broadly a 75% allocation to truly illiquid assets.[100] The regulatory changes that enabled the development of LTAFs offer a useful precedent for the industry. If a new category of funds offers a suitable approach, collective action would be required. For example, industry stakeholders should engage on the definition of suitable structures, the development of plans to address liquidity mismatches, and how to place these funds on platforms.

Collective action

Future Growth Fund

A potential vehicle to accelerate the collective action necessary of the industry would be the development of a Future Growth Fund (FGF) that takes into consideration the regulatory and non-regulatory components in its design and implementation.

Discussions with the senior industry professionals indicated broad agreement with the concept of a fund to diversify the risk of actions taken by individuals or a small cohort. This would also facilitate the change around the broader market and cultural change which is required to structurally move the industry forwards.

A fund would need to be of the appropriate size and scale to deliver meaningful impact and a headline figure of £50b is proposed, equating to 5% of UK DC pension fund assets. The approach to scaling such a fund in terms of AUM and phasing over time, including the deployment targets and the sub sectors of FPS Tech, would need to be considered in the detailed design.

> If [pension funds] are left to their own devices, the current approach will continue. There needs to be a co-ordinated approach to create a significant pool. It should mostly be a fund of funds with some kind of incentive for joining to get it off the ground.

Various options exist to achieve a £50b fund, from mandatory participation through regulatory and legislative mandates to greater incentivisation for schemes to join through their own volition. Regardless of the mechanism to seed such a fund, a level of consensus from the industry will be critical to achieving success.

> Legislation and regulation are the only way we get everyone on the same page.

> There should be no interfering with the investment strategies of pension funds by dictating what they must invest in.

There was broad agreement amongst interviewees that a collective approach would be helpful from a commercial perspective; acting together would mean that no single scheme faces increasing fees above the norm. Interviewees also suggested a phased approach to allocation would be most suitable, with the majority suggesting a target allocation of 5% of AUM to FPS Tech investments over a number of years.

> A realistic place to start is getting 5% from DC funds into scale-ups.

> Funds are not going to throw everything at it all at once but you can get to 5% gradually over five years.

Mandatory or target investment allocations to private capital

Mandating the alteration of default investment pathways to include allocations to private capital presents an opportunity to deliver change at scale. This would mean that the majority of UK savers would be exposed to and able to benefit from the returns offered by private capital. There was strong consensus amongst interviewees that younger savers with longer timelines and higher risk appetites should be more exposed to private capital.

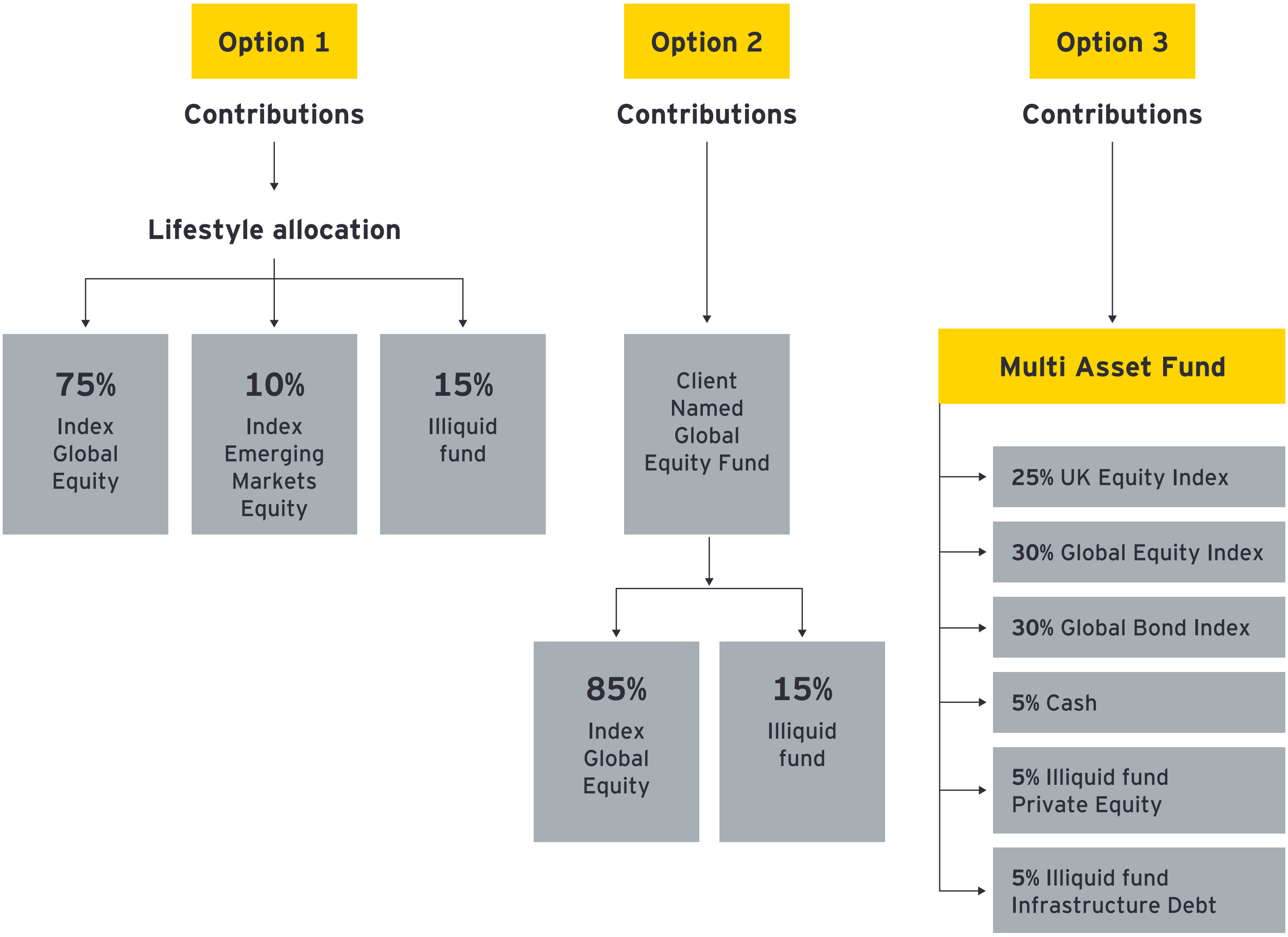
> If you get a 25-year-old, of course they should have a bigger exposure to VC.

Our research suggests recommending – rather than requiring through primary legislation or regulation – pension schemes to include private capital would be the more effective approach. Additionally, interviewees indicated that mandatory allocations may cause significant pushback and are unlikely to impact cultural change. In contrast, education and guidance on the potential long-term benefits of private capital allocations are widely viewed as a good first step. A soft regulatory approach – i.e., one that emphasises guidance – could be more suitable.

Structuring funds that hold FPS Tech and other illiquid assets within a default strategy

Many of our research participants believe that DC pension funds should be structured to hold more illiquid assets (including FPS Tech) within the default asset allocation. Our findings are consistent with a 2022 survey of DC pension professionals, which found that 55% of respondents supported the use of illiquid assets within DC default schemes.[101] Participants in our research, who were also engaged with the PFWG, expressed confidence that they could manage liquidity whilst investing into illiquid assets as part of a diversified portfolio within their default arrangements.[102]

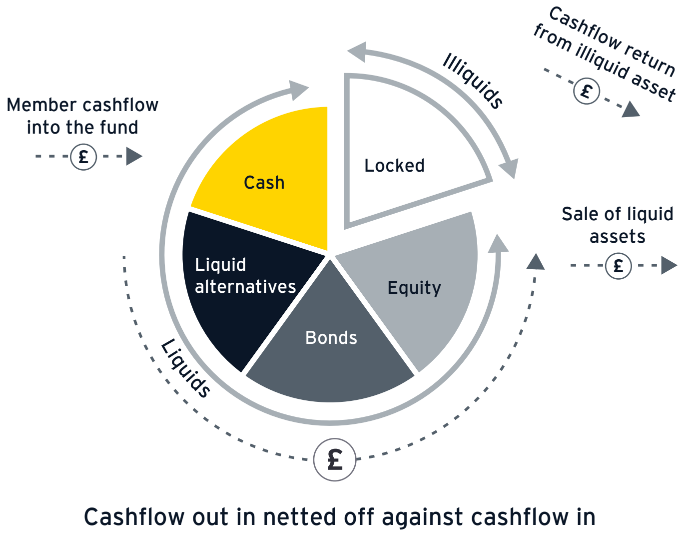
Figure 13: Allocating to less liquid assets within a DC default arrangement



Source: Productive Finance Working Group

The managed blended fund solution is one approach to enable illiquid investments within default strategies. This approach is outlined in a paper by the Institute and Faculty of Actuaries, whereby "an Investment Manager is able to choose, for a consolidated solution (i.e., at scale), how much of the illiquid asset is held within each stage in the members' journey (potentially within a Target Dated Fund structure). Then, through reliance on the DC cashflow, they can create a secondary market whereby the illiquid assets of older retiring members are bought by the younger members."[103]

Figure 14: Structure for illiquid investments within default DC strategy



Source: Institute and Faculty of Actuaries

Our research found that changes to the default asset allocation strategy would likely require collective action from both pension fund market participants (e.g., DC pension schemes, trustees, consultants, asset managers, insurers) and regulators. Regulatory guidance would likely be needed to ensure all active and deferred members of schemes are treated fairly and equally. There is also an onus on consultants to provide trustees with recommended asset allocations for the default strategies, including the allocation to FPS Tech, VC and PE. The guide to investing in illiquid assets from the PFWG is a useful tool,[104] which can help prompt some of this collective action.

Consolidation of smaller DC pension schemes

Our research found that the importance of scale as an enabler to unlock institutional capital within the DC pension market is widely recognised by both the government and industry. Many participants believed that the trend of consolidation would reach a steady state. Allowing consolidation to run its course would naturally erode some of the challenges outlined in this report, including the lack of private market expertise, the focus on cost over value, and other structural issues in the governance of DC schemes. Importantly, it was confirmed in the June 2021 government consultation response that it will become a requirement by law for schemes below £100 AUM to publish the net returns of the default arrangement where the requirement at present is only to publish costs and charges. This will enable a shift in the discussion on what constitutes 'good value' from simply 'the cheapest' to a broader assessment of value.

Utilising local government pensions schemes (LGPS), which have assets of approximately £364b[105] and are considered as an early mover, could be one way to demonstrate the benefits of consolidation.

> Either a cultural shift or merging all of the local authority pension schemes through primary legislation are the only two things you can do to address the supply-side issue.

In addition to consolidation, LGPS invest into PE and illiquid assets. In 2022, PE and private debt overtook property as the second and third most popular alternatives for LGPS. For instance, the £38.3b Border to Coast Pensions Partnership, which handles the assets of 11 LGPS funds, completed the final £1.5b of investment within its private market offering in early 2022. However, LGPS funds allocated a net £10.4b to illiquid alternatives in 2019, about 24% more than was invested in 2021.[106]

A recent survey of 100 LGPS fund professionals in England and Wales reported that 91% of respondents predicted their funds would increase allocations to private markets and 60% expected the rise to be between 5% and 10%.[107] Local authority pension pooling vehicles Brunel Pension Partnership and London CIV have launched new private market funds with commitments from their pension fund clients totalling £1.7b. Brunel is also working with Aksia to build a bespoke portfolio of funds targeting corporate direct lending strategies in Europe and North America. Pension funds served by Brunel have committed £945m to the pooled fund.[108]

Data suggests there is momentum towards creating more pooled funds that large single employer trusts can access in the future. However, with further consolidation on the horizon, small schemes may decide this is too difficult to prioritise in the short to medium term; hence there is a 50/50 chance of small schemes using pooled vehicles according to PPI and DCIF.[109] A much larger pooled fund may be the more attractive proposition, especially if it includes various investments with different time horizons to allow more liquidity.

Education and awareness building with industry

The importance of industry knowledge regarding private capital across the pensions value chain was a consistent theme throughout the research. Consultants and professional trustees have significant influence on the strategies and key investment considerations of pension schemes and should be at the forefront of supporting and educating the broader ecosystem. The work by the PFWG is one example of this and both consultants and professional trustees should engage with their guides.[110]

Access and availability of information regarding UK FPS Tech and scale-up ecosystems was another consistent theme, as those in the pensions and asset management industries seem to have limited exposure to sources. Trade bodies and government departments, including the centre for finance innovation and technology (CFIT) and the department for science, innovation and technology (DSIT) need to consider their roles in information sharing and raising awareness of FPS Tech with the pensions industry.

Those within the pensions and asset management industry should be encouraged to consider the opportunity for risk adjusted returns, rather than simply focusing on keeping scheme costs low. There is likely a role for the regulator in encouraging this shift in awareness and education. For example, the regulators could issue a joint statement acknowledgement the private markets' growing size and impact on UK capital markets. Further, they could share evidence that investing in private capital offers the potential for higher long-term returns, compared to other asset classes, making them suitable for pensions (especially as part of younger savers' investment strategies). Such a statement would increase pension schemes' confidence in regulatory support for investing in private markets, especially if specific regulatory guidance were included.

Changes to reporting and disclosure standards for pension funds

The current reporting from UK pension schemes is focussed on costs and this is reinforced through how value for money is portrayed,[111] with little information on investment strategy and asset classes invested in communications. The current wording states "In our view, charges and transaction costs are likely to represent good value for members where the combination of costs and what is provided for the costs is appropriate for the scheme membership as a whole, and when compared to other options available in the market."[112] It should be noted that there is a caveat that "value for members does not necessarily equate to low cost." There is limited focus on risk-adjusted returns in current reporting and there could be value in communicating the importance of that as part of the value for members.

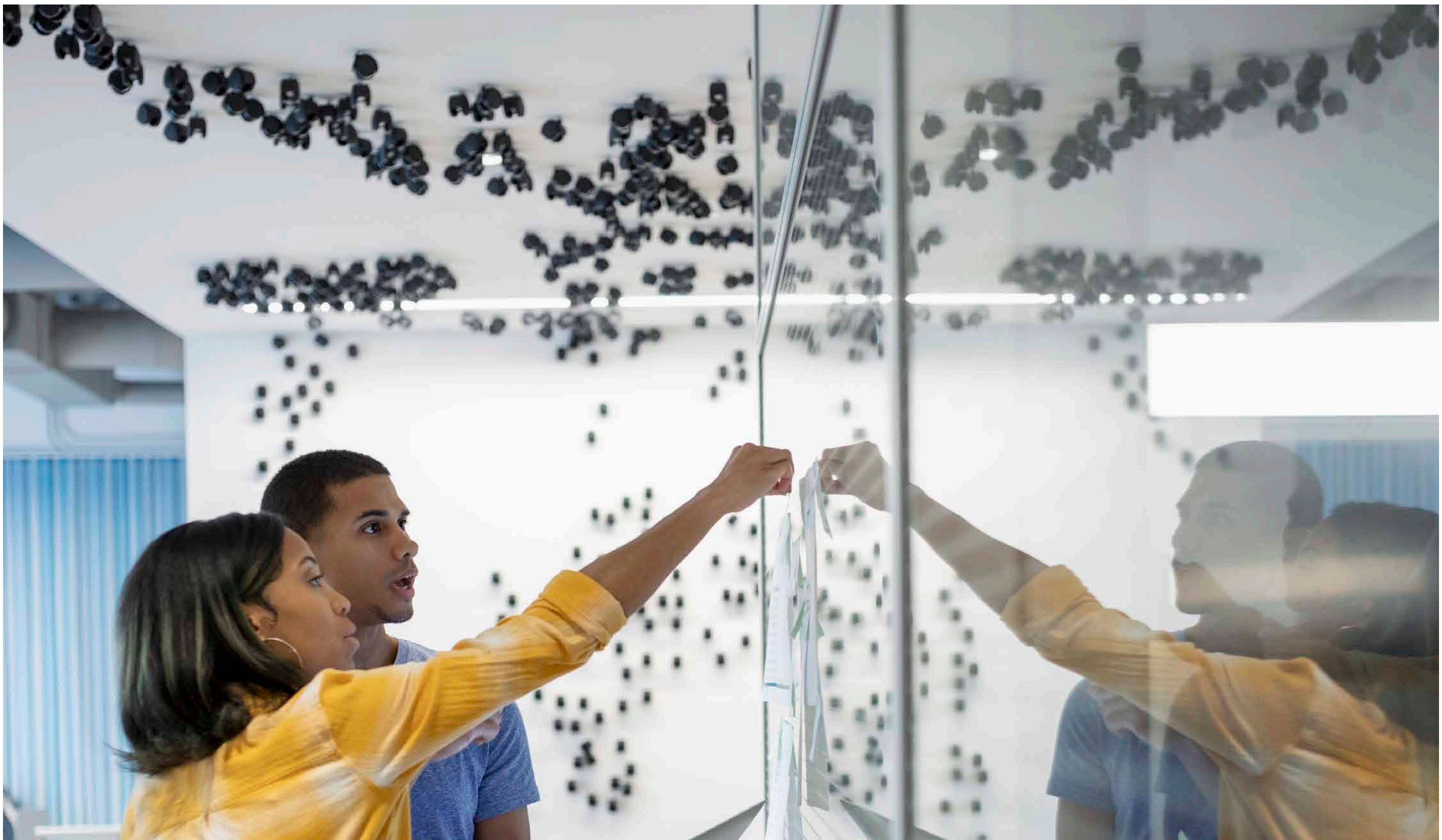
The Australian regulator conducts an annual assessment of 69 superannuation products with at least five years of performance history against an objective benchmark that assesses two components: investment performance and fees/costs.[113] Similarly, the Association of Superannuation Funds of Australia publishes collective statistics for the industry,[114] which include the rate of return for entities.

Figure 15: Australian Superannuation investment returns to June 2022

Period (% pa)	Fund returns	Real returns vs. CPI
1 year	-3.3	-8.9
5 years	5.8	3.1
10 years	8.1	5.7
20 years	6.6	4.0
30 years	7.3	4.7

Source: ASFA

This approach, which would likely need to involve consultation between government, regulators and industry, could be replicated in the UK.



Conclusion

The UK FPS Tech sector represents a significant opportunity for DC pension funds and other institutional investors to generate returns at the growth stage and for the underlying pension scheme beneficiaries. The recommendations in this report are intended to demonstrate how that objective can be achieved.

It is worth noting that investments by DC pension funds into FPS Tech and other productive assets could have a wider societal benefit. Private pension wealth identified in the last Household Wealth and Assets Survey was £5.4t (or 42% of the household wealth of the UK). Of those pension assets, 69% were invested in the UK and 31% abroad.[115] So, even a small change in focus could add hundreds of billions to economically productive sectors across the UK. For example, closing the FPS Tech growth funding gap could provide a 10-20% boost in business investment and double the number of scale-ups in the UK.[116]

Many of the challenges described in this report are structural. Thus, collective action will be critical to moving the growth agenda forward – and there needs to be a catalyst for this collective action.

The FGF could therefore help attract further investment into the UK and grow the overall health of the economy, in addition to the businesses supported by the fund. This may be the catalyst that the UK needs to unlock DC pension capital and help FPS Tech grow. It is important for industry, regulators and government to collaborate and explore how to progress with this concept.

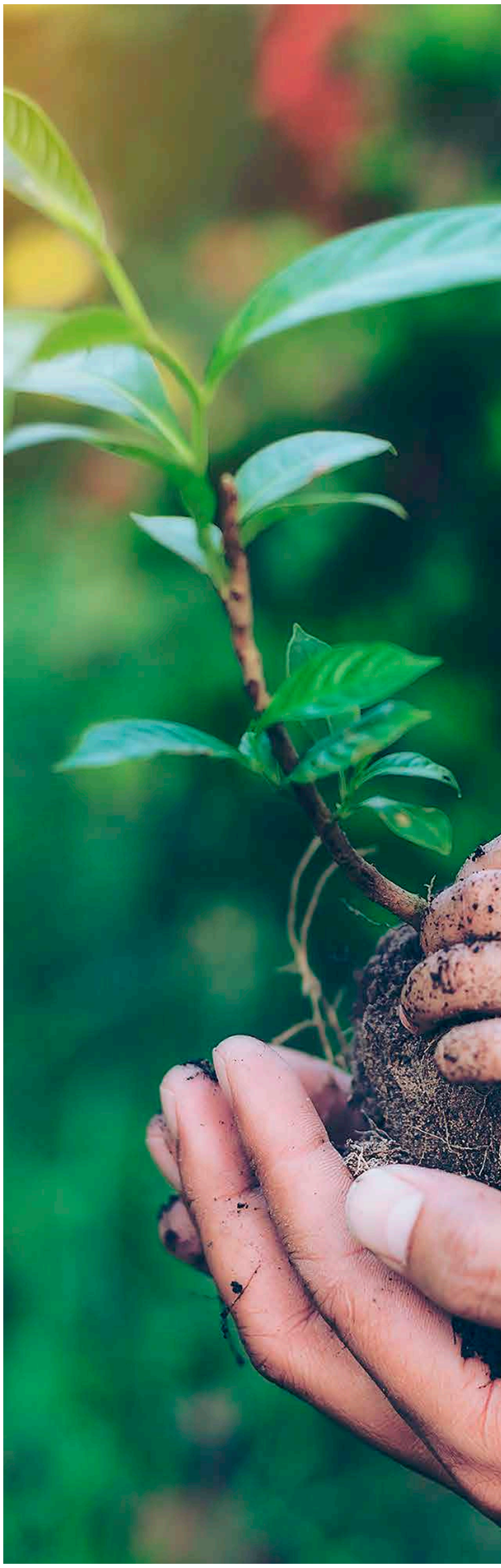
Cutting-edge companies across high-growth sectors need access to sufficient finance to be able to start, scale and stay in the UK. Since the Patient Capital Review in 2017,[117] the government has delivered a series of reforms to increase investment into innovative scale-up companies, leading to a halving of the UK's VC financing gap with the US. As stated in the Spring Budget 2023[118] – "To develop the next generation of globally competitive companies that grow and list in the UK, and to bolster the retirement incomes of millions of ordinary people, it will be critical to unlock DC pension fund investment into the UK's innovative firms. The government has already taken important steps to address existing challenges and to lay the foundation for further progress. The government will work closely with industry and regulators to bring forward an ambitious package of measures by the autumn."

> "
>
> If industry is left to its own devices, the current approach will continue. There needs to be a coordinated approach to create a significant pool … with some kind of incentive for joining to get it off the ground.

End notes

1 UK tech sector retains #1 spot in Europe and #3 in world as sector resilience brings continued growth – GOV.UK
2 The UK Financing Gap – The European Financing Gap
3 Unlocking the capital in capital markets – New Financial
4 Unlocking the capital in capital markets – New Financial
5 A roadmap for increasing productive finance investment – Bank of England
6 The future of defined contribution pensions – British Business Bank
7 DC trust scheme return data 2020 – 2022 – The Pensions Regulator
8 UK tech sector retains #1 spot in Europe and #3 in world as sector resilience brings continued growth – GOV.UK
9 UK tech sector retains #1 spot in Europe and #3 in world as sector resilience brings continued growth – GOV.UK
10 Kalifa Review of UK Fintech – GOV.UK
11 Productive Finance Working Group – Bank of England
12 A roadmap for increasing productive finance investment – Bank of England
13 Investing in less liquid assets key considerations – PLSA
14 Kalifa Review of UK Fintech – GOV.UK
15 CMIT – Capital Markets Industry Taskforce
16 Unlocking the capital in capital markets – New Financial
17 Facilitating investment in illiquid assets by defined contribution pension schemes – GOV.UK
18 Draft statutory guidance: Disclose and Explain asset allocation reporting and performance-based fees and the charge cap – GOV.UK
19 Spring Budget 2023 – GOV.UK
20 Long-term Investment For Technology and Science (LIFTS) initiative: request for feedback – GOV.UK
21 PS21/14: A new authorised fund regime for investing in long term assets – FCA
22 Spring Budget 2023 – GOV.UK
23 UK tech sector achieves best year ever as success feeds cities outside London – GOV.UK
24 The Complete List of Fintech Unicorns in the UK in 2023 – Startups of London
25 Fintech Investment Landscape 2022 – Innovate Finance
26 Fintech Investment Landscape 2022 – Innovate Finance
27 Patient Capital Review – GOV.UK
28 Patient Capital Review – GOV.UK
29 The Future of Growth Capital August-2020
30 The UK Financing Gap – The European Financing Gap
31 Pension charges survey 2020 – summary – GOV.UK
32 Pension charges survey 2020 – summary – GOV.UK
33 A roadmap for increasing productive finance investment – Bank of England
34 Pitchbook, data accessed 09/03/2023
35 Startups & scaleups – Dealroom.co
36 Performance Measurement Survey 2021 – BVCA
37 Performance and Public Market Equivalent Report 2021 – BVCA
38 Performance Measurement Survey 2021 – BVCA
39 Growing Great British Businesses 2022 – BVCA
40 Kalifa Review of UK Fintech – GOV.UK
41 A roadmap for increasing productive finance investment – Bank of England
42 The future of defined contribution pensions – British Business Bank
43 Law Commission Pension Funds and Social Investment No.374
44 Defined ambition pension schemes – House of Commons Library
45 Investment Returns: Defined Benefit vs. Defined Contribution Plans – Center for Retirement Research
46 DC trust: scheme return data 2022 to 2023 – The Pensions Regulator
47 Aon DC member survey reveals worsening retirement savings gap for UK employees – Aon
48 The future of defined contribution pensions – British Business Bank
49 The future of defined contribution pensions – British Business Bank
50 The future of defined contribution pensions – British Business Bank
51 Teachers' Innovation Platform becomes Teachers' Venture Growth as part of ambitious growth plan – OTPP
52 How we invest – Hostplus
53 Patient Capital Guide – PLSA
54 Q&A: Lakestar explains the UK's $1.8t growth funding gap – PitchBook
55 Review of the Default Fund Charge Cap and Standardised Cost Disclosure – GOV.UK
56 Review of the Default Fund Charge Cap and Standardised Cost Disclosure – GOV.UK
57 The folly of the fetish for liquidity – Natixis
58 It's Complicated: A Guide to Private Equity Fees – Evercore
59 Review of the Default Fund Charge Cap and Standardised Cost Disclosure – GOV.UK
60 Draft statutory guidance: disclose and explain asset allocation reporting and performance-based fees and the charge cap – GOV.UK
61 DC trust scheme return data 2020 – 2021 – The Pensions Regulator
62 European Asset Allocation Insights 2021 – Mercer
63 Incorporating performance fees within the charge cap – GOV.UK
64 UK Strategy for Financial Wellbeing 2020-2030 – Money and Pensions Service
65 The key to unlocking member engagement – The Defined Contribution Investment Forum
66 DC investment under the microscope, with the Virtual Panel – The Defined Contribution Investment Forum
67 The Royal Mint reveals young people are set to invest £9.4b as alcohol, travel and buying fast fashion take a seat – The Royal Mint
68 What ordinary people think about responsible investing – Quietroom
69 FCA authorises first Long Term Asset Fund – FCA
70 Long-term Investment For Technology and Science (LIFTS) initiative: request for feedback – GOV.UK
71 DC growth indicates automatic enrolment is starting to mature – The Pensions Regulator
72 Defined contribution pension market consolidation continues, TPR's latest figures show – The Pensions Regulator
73 Defined contribution pension market consolidation continues, TPR's latest figures show – The Pensions Regulator
74 Future of the defined contribution pension market: the case for greater consolidation – GOV.UK
75 DC: A brave new world – Portfolio Institutional
76 DC: A brave new world – Portfolio Institutional

77 Pitchbook, data accessed 09/03/2023
78 Pitchbook, data accessed 09/03/2023
79 Gaps in financing of UK entrepreneurial ventures – SBS
80 The Walker Guidelines and Private Equity Reporting Group – BVCA
81 The Walker Guidelines and Private Equity Reporting Group – BVCA
82 Reports – PERG
83 Report on the Performance of Portfolio Companies – PERG & EY
84 Putting investment in the heart of DC Pensions – The IA
85 Putting investment in the heart of DC Pensions – The IA
86 Target end-states for defined benefit pension scheme paper 11 Dec – Institute and Faculty of Actuaries
87 DC investment under the microscope, with the Virtual Panel – The Defined Contribution Investment Forum
88 PS21/14: A new authorised fund regime for investing in long term assets – FCA
89 Statutory guidance: Simpler annual pension benefit statements – GOV.UK
90 Communicating reporting DC pension schemes – The Pensions Regulator
91 Super Statistics – ASFA
92 Compare the Pair tool – Industry Super
93 Measuring Super Performance – AustralianSuper
94 Invest in innovation | Aware Super – Australian Superannuation Fund
95 Employee engagement toolkit – Nest Pensions
96 Communicating reporting DC pension schemes – The Pensions Regulator
97 Pitchbook, data accessed 09/03/2023
98 Pitchbook, data accessed 09/03/2023
99 Long-term Investment For Technology and Science (LIFTS) initiative: request for feedback – GOV.UK
100 Illiquidity white paper – Institute and Faculty of Actuaries
101 Illiquids should be in DC defaults, industry agrees – Professional Pensions
102 Investing in less liquid assets key considerations – PLSA
103 Illiquidity white paper – Institute and Faculty of Actuaries
104 Investing in less liquid assets key considerations – PLSA
105 Spring Budget 2023 – GOV.UK
106 LGPS funds pile into illiquid alternatives amid soaring inflation – DB & Derisking – Pensions Expert
107 91 of LGPS Funds Set to Increase Allocations to Private Markets – Alpha Real Capital
108 Brunel launches Private Debt portfolio with Aksia – Brunel Pension Partnership
109 PowerPoint Presentation – Pensions Policy Institute
110 Investing in less liquid assets key considerations – PLSA
111 Driving value for money in defined contribution pensions – The Pensions Regulator
112 DC code of practice – The Pensions Regulator
113 APRA releases 2022 MySuper performance test results – APRA
114 Super Statistics – ASFA
115 UK Strategy for Financial Wellbeing 2020-2030 – Money and Pensions Service
116 The Future of Growth Capital – August-2020
117 Patient Capital Review – GOV.UK
118 Spring Budget 2023 – GOV.UK



EY Contacts:

Axe Ali
Partner, Private Equity and
Venture Capital
axe.ali@parthenon.ey.com

Thomas Bull
Partner, UK FinTech Growth Leader
tbull1@uk.ey.com

Oliver Carew
FinTech Strategy
oliver.carew@uk.ey.com

Support provided by:
Ellie Marsh (Senior Consultant)
Sam Letts (Consultant)
Sam Riodran (Director)

City of London Corporation Contacts:

Martin Bailey
Head of Strategic Business Relationships
& Growth Capital Initiative
martin.bailey@cityoflondon.gov.uk

Gordon Mead
Head of Regulatory Policy
gordon.mead@cityoflondon.gov.uk

Marco Ciao
Senior Research Advisor
marco.ciao@cityoflondon.gov.uk

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

UKC-028094.indd (UK) 03/23. Artwork by Creative UK.

ED None

In line with EY's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

ey.com/uk