VFM Policy Team
Financial Conduct Authority
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Sent by email to: vfmconsultationpaper@fca.org.uk

Dear VFM Policy Team,

FCA CP24/16: The Value for Money Framework - BVCA Response

The BVCA is the industry body and public policy advocate for the private equity and venture capital (private capital) industry in the UK. With a membership of over 600 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. In 2023, £20.1bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside of London and 90% of the businesses receiving investment are small and medium-sized businesses.

The BVCA has been working closely with industry experts across the pensions and private capital industries over many months to consider how best to enable more pensions investment to flow into private capital funds to achieve better outcomes for pensions savers and to drive growth in the UK. Together with the Association of British Insurers, the Pensions and Lifetime Savings Association, and the broader pensions industry, the BVCA established an Expert Panel of senior pensions and private capital industry leaders to find solutions to technical, market and policy challenges. Since January 2024, both the Expert Panel and a 50-person 'Technical Expert Group' have been working together to examine solutions to the issues and drive meaningful change in this space. The Interim Report of the Pensions & Private Capital Expert Panel makes a series of recommendations, including on value for money considerations.

The importance of reform to pensions investment and getting it right is highlighted by BVCA data showing that 16 times more capital from pensions around the world goes into UK private capital funds than from UK pensions. UK pension savers are missing out on the returns generated by private capital funds in the UK, which pension savers in other countries currently benefit from.

We welcome the opportunity to provide feedback in response to this consultation and below we have answered some of the questions included in it. Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of this response in more detail (please contact Tom Taylor ttaylor@bvca.co.uk or Karen Hurst khurst@bvca.co.uk).

<u>**Summary of key feedback**</u>

- The BVCA welcomes this considered consultation on the value for money framework. We strongly support embedding a focus on long-term value for DC pension schemes and we are positive about the framework's clear aim of facilitating a wider range of investments by DC pensions. We fully support the clear intention that the framework applies to all DC pension schemes.

- One of the key recommendations of the report published by the BVCA-convened pensions and private capital expert panel, as set out in the Interim Report of the Pensions and Private Capital Expert Panel (p.14), is that "the pensions industry should be empowered by government and regulators to move away from short-term cost considerations to long-term returns by DC pensions".

- We recognise that the proposed value for money framework is asset-class neutral, but it is our view that a clearer regulatory focus on long-term value will result in greater diversification in asset allocations, in the interests of both UK DC savers and UK economic growth.

- We think it is important that the FCA considers further how forward-looking metrics might be incorporated into the framework. There remains a risk that, without some consideration of forward modelling, the framework will not be effective as regards long-term private capital investments for some years.

- To ensure asset allocation disclosures are useful as part of the framework, we recommend the FCA provide further guidance to schemes (beyond the definitions in the draft regulations) on determining whether an investment in the private equity category should be recorded as venture capital, growth equity, buyout or "other". We also emphasise the importance of clarity as regards the timing of when a scheme should record as an allocation an investment in a typical private capital fund.

- We have some more significant concerns about some aspects of the proposed framework and in particular the assessment approach which we urge the FCA to address. We think the current proposal for the assessment process may penalise schemes that are investing over the long-term in alternative asset classes. It is important that the framework allows IGCs sufficient flexibility to take a more holistic and forward-looking assessment of investments. At the moment the proposed assessment process does not appear to allow for this. In our view, this not only risks failing to change the approach to long-term value, but may actually further discourage DC investment into long-term investments such as private capital.

- As regards the proposed Amber and Red ratings, we recommend that such a system is used in a way that encourages and allows improvements to be made by schemes. We support the proposal that schemes set out clear plans for improvement and make some suggestions for further refining this system.

- We strongly support legislation being implemented that would enable the FCA to enforce the bulk transfer of pension pots in instances where a scheme has a Red rating as a result of a VfM assessment. This is essential in ensuring that savers in contract-based schemes have the same protections as those in trust-based schemes. We urge the Government to take this forward in the forthcoming Pension Schemes Bill.

BVCA responses to selected questions from the consultation

Question 1: Do you agree with the proposed scope, thresholds and exclusions? Why or why not? If not, what alternatives would you suggest?

We agree that the approach set out in the consultation paper appears sensible, though we would like consideration to be given to the position of 'hybrid' schemes (those with connected DB and DC offerings) when forming the final rules. We recognise that there are examples of those arrangements already offering diversified investment strategies and strong returns, and urge the FCA to ensure the final framework does not infringe upon this.

We are pleased to note the intention for the new framework to be adopted by both FCA and TPR, so that it will apply to both trust-based schemes and Group Pension Plans. This is essential to ensure that comparisons are made across the market by schemes when assessing value, and that two separate systems do not develop. As these rules are developed and the Pension Schemes Bill progresses, we think it is very important that the need for consistent requirements continues to be prioritised.

Below we have also set out why, in our view, legislation will be required to enable the FCA to make directions in relation to schemes identified as performing poorly, as TPR is able to.

Question 4: Do you agree with the proposed investment performance metrics? Why or why not? If not, what alternatives would you suggest?

Overall, in our view, the proposed disclosures are sensible and we support the proposal to require IGCs to make their assessment of investment performance net of investment charges only. Given the strong consensus that has now developed on the importance of moving away from short-term cost as the key consideration in relation to investment decisions, as well as the existing requirements for DC schemes to disclose costs, we urge the FCA to consider whether the number of data points here might be reduced.

Nevertheless, we do recognise the importance of transparency. The recent report by the Pensions and Private Capital Expert Panel (pp. 43-44) flagged the volume and inconsistency of cost disclosure rules across both DC pensions and the rest of the investment chain as a point of friction. We therefore suggest that, in finalising these requirements, consideration be given to how the cost disclosure rules interact with existing requirements for DC schemes, and whether there continues to be undue focus on short-term costs.

Question 8: Do you have further feedback on the incorporation of forward-looking metrics within the Framework? If included, how prescriptive do you think we should be on assumptions and methodology, and what would you propose?

We are concerned that the proposed data points are solely backward looking. We welcome the growing interest in private capital investments recently (evidenced by initiatives such as the Mansion House Compact), but note that DC schemes currently do not have meaningful investments in this asset class. Given the long-term profile of private capital fund returns (where performance tends to manifest itself more clearly in the second half of a fund's typically 10+ year life), there is a danger that initial assessments lacking track record and backwards looking data, might not accurately reflect the anticipated long-term performance of schemes that have begun to make such investments (but those investments have not yet matured). There remains a risk that, without some consideration of forward modelling, the framework will not be effective as regards private capital for some years.

We recognise that there is no clear consensus on which metrics might meet this brief, as well as concerns about the possibility of 'gaming'. However, we recommend that the FCA and TPR continue to explore this issue, and work with industry to provide further guidance on how schemes can appropriately account for potential future performance to ensure that the most useful information is available to decision-makers in IGCs and to other stakeholders.

Below we have highlighted the importance of IGCs having the ability to exercise discretion in their assessments, which is especially important in the absence of a forward-looking metric.

Question 9: Do you agree with the approach to asset allocation disclosures? Why or why not? If not, what would you suggest? Do you think asset allocation disclosures will support better decisions in the interests of savers?

Overall, we think the proposals are reasonable but have some recommendations for how they could be further improved.

It may be helpful for the FCA to provide further guidance to schemes (beyond the definitions in the draft regulations) on determining whether an investment in the private equity category should be recorded as venture capital, growth equity, buyout or "other". We recommend the FCA consider the definitions suggested in the Pensions and Private Capital Expert Panel Interim Report in this regard (pp.91-92).

We would also like to draw the FCA's attention to the importance of clarity as regards the timing of when a scheme should record as an allocation an investment in a typical private capital fund (which will operate a drawdown model under which capital is committed by the investor at the outset then periodically drawn down from them on notice as the fund acquires portfolio companies). We would expect that the moment capital is drawn down from the scheme (i.e. money is actually provided to the fund) should be the point that a DC scheme's commitment to a private capital fund, which may contractually have been made several years earlier, should become an "allocation" for the purposes of the framework. This would be straightforward to execute and would avoid double counting where an amount is committed to a private capital fund but not actually transferred (and remains held by the scheme as liquid assets until they are liquidated to meet a draw down notice). We strongly recommend this definition of an allocation be made clear in the rules or guidance.

We also note the importance of the requirement to disclose any information that would be considered material to performance. Given the long-term investment horizons of private capital, and the 'j-curve' effect of individual funds that means investments can appear potentially misleadingly to make a loss in the initial years (although this can be 'smoothed' across a well-constructed private capital program with multiple fund investments of different maturities), it is essential to the overall ambition to move away from short-term cost considerations to ensure that the background is available to IGCs in making their assessment. Unless the framework enables this, there is a clear danger that it could effectively restrict DC schemes' ability to invest in UK private capital.

Question 12: Do you agree with the proposed definitions for UK assets? If not, what would you propose?

The approach for private equity (which includes venture, growth, buyout and "other") seems broadly sensible. Before finalising the definitions, we suggest the FCA considers the sub-asset class definitions included Pensions and Private Capital Expert Panel Interim Report (pp. 91-92) when considering whether further guidance on sub-asset class distinctions is required for these purposes.

However, we urge the FCA to consider further guidance on determining whether a portfolio business of a private equity (including venture etc.) fund is a UK registered company or partnership. Corporate holding structures for private equity-backed companies can be located in different jurisdictions and it is relatively common for a UK-headquartered company to be held through shares in a non-UK parent company. We strongly recommend that this determination should focus on the location of a company's head office rather than the domicile of the company whose shares the fund owns.

Question 13: Do you think we should break out 'Quoted but not listed' (eg AIM) and if so, how would that be useful? Would there be additional cost to doing this and can you indicate how much?

Though we are of the view that there is a lack of data on the assets held by UK DC pensions, we also recognise the need for proportionality and the volume of mandatory data points already required, so on balance it is our view that this should only be a requirement where a scheme feels it is material information for IGCs.

Question 14: Do you agree with the proposed costs and charges metrics? Why or why not? If not, what alternative metrics would you suggest?

We are aware that there appear to be a number of examples of employers covering the costs of some DC arrangements. Under these proposals those costs would be reported in the same way as costs picked up by members.

We appreciate that the audience for this data is primarily IGCs, and it is not unreasonable to consider the appropriateness of those costs in the round, irrespective of who is covering them. However, we also would flag the importance of ensuring that communications to members on this accurately reflect the benefit members receive for those costs. This includes communications that come about as a result of third party assessments and any 'league tables' that emerge. This is because the issue of whether an employer covers costs is a significant factor in any assessment of whether or not a member is receiving value. Unless there is legislative change, the success of the FCA rules may depend on members acting in situations where they are receiving poor value. We would therefore encourage the holistic consideration of how costs are communicated to members, taking into account subsidies and whether they are receiving long-term value overall.

Question 21: For each of the five proposed indicators, do you agree with the proposed metrics for measuring these? If not, what metrics would you suggest? We would particularly welcome views on these metrics.

We agree with the reference to the framework evolving to include decumulation metrics, once the Pensions Bill provisions on this have been implemented. Our recent work with the Pensions and Private Capital Expert Panel highlighted the importance of the right decumulation options being in place to ensure member pots have the right time horizons and scale. We therefore would support decumulation forming part of the future framework.

Question 26: Do you agree with the assessment process we have outlined above? Do you have views on what should be considered a material difference in value relative to comparator arrangements? If you think that RAG ratings will not be sufficiently comparable, what refinements would you suggest?

This is the area of the consultation that we have the most significant concerns about.

The process set out in the consultation paper is fairly prescriptive, and we recognise a need for some level of standardisation across the framework.

Nevertheless, despite the framework's clear aim of facilitating a wider range of investments by DC pensions, we have concerns that the proposed assessment process risks discouraging private capital investments. This is because the long-term investment horizons, and the j-curve pattern of returns, often mean that individual fund investments experience strong performance later in their holding period. The proposals do not provide sufficient reassurance that IGCs will be able to consider these core features of private capital investments in their assessments.

The proposed assessment approach appears to focus mainly on how a scheme performs relative to the selected comparators. In a landscape where the level of private capital investment is relatively low compared to other nations, we are concerned that this will effectively discourage any scheme to be a 'first mover' given the clear risk that, in the short term, they could find themselves categorised 'Amber' because comparable schemes have not made private capital investments. This is particularly concerning given the views raised by the pensions sector that an Amber classification offers no realistic 'way back' for schemes.

For example, Paragraph 8.38 states that that: *'changes to the design of an arrangement that have not yet shown through in the Framework data should not be considered in determining a rating. These will show through over time if they deliver as anticipated'.*

We are concerned that this will not only fail to change the approach to long-term value, but may actually further discourage DC investment into long-term investments such as private capital. Given the body of evidence demonstrating the potential benefits of private capital investment for DC savers, we do not believe that guidance of this nature will provide IGCs with the tools to make a balanced decision.

In addition, Paragraph 8.39 states that *"If an arrangement underperforms its comparators, contextualisation may explain this and a green rating can still be attributed… contextualisation should only refer to saver and employer demographics, and any special features or characteristics of arrangements that may affect value delivered for savers".*

This proposed wording does not make it sufficiently clear that the long-term investment considerations would be a legitimate consideration for IGCs when addressing short-term performance issues.

We note that the paper also sets out that arrangements must not be materially worse, but that it is not proposed that a definition of 'materially' will be provided. From our reading of this section, we take the view that ICGs would not have the ability not to downgrade a scheme's rating because of short-term performance dips on long-term investments, even where it had no impact on long-term saver outcomes, and where there was reasonable context for it.

In order to address these concerns, we recommend that:

- It be made clear that IGCs have the ability to make a judgement on apparent short-term performance dips, where they seem to be the consequence of long-term investments made with the prospect of increasing returns, and where they are considered suitable for the demographic.
- The guidance makes clear that investments can be a consideration when contextualising apparent underperformance.
- The FCA works with industry to explore suitable forward-looking metrics and enables IGCs to consider the anticipated impact of investments (as suggested above).

We urge the FCA to note and take forward these recommendations, so that it can achieve its aim of facilitating a wider range of investments by DC pensions, including into private capital.

Question 29: Do you agree that IGCs should consider and report on whether their firm's current scale may prevent it from offering value to savers? If not, what would you propose?

We agree that this should be considered as part of IGC assessments, given the clear evidence that scale can be a factor in delivering value. Data from CEM suggests pension schemes of around £20bn typically invest 20% in private markets. In the UK, this is demonstrated through Nest, which is targeting a 30% allocation when it reaches £100bn (around 2030), which is more typical of leading private markets investors globally. Though we acknowledge that scale should not be the only factor, there is a clear relationship between scale and value, and it therefore should be a consideration in IGC assessments.

Question 31: Do you agree that firms should inform employers of amber and red ratings and proposed steps to address the poor value, where an employer's current and past employees are at risk? If not, why not and what would you suggest?

We agree with this proposal. Given the important role that employers play in the assessment and provision of pensions for their employees, we do not see good reason for the information to be withheld. We note that the employer would not, in contract-based schemes, be in a position to act quickly. However, we believe that better engagement by employers is useful overall, and in the long term may alter how employers approach the selection of pension providers, which would be in the interests of savers.

Question 32: Do you agree that firms should not be allowed to accept business from new employers into an arrangement rated amber or red? If not, why not and what would you suggest?

We agree that this is a sufficiently high bar for those schemes found to not be offering value for money. If there are no clear repercussions, such as this, then the framework risks becoming merely a disclosure regime.

However, though the consultation paper states that in-year reassessments can be carried out (for example, to assess actions taken by a scheme to address concerns raised as part of an Amber assessment outcome), we understand that many are concerned that this may not be practical due to a lack of comparative data.

It is important that Amber assessments provide an opportunity for schemes to address concerns. The proposals suggest that an Amber rating should be applied where there is a likelihood that the issues can be addressed within a reasonable timeframe. We therefore suggest that the FCA provide further guidance, setting out its expectations of schemes undergoing an in-year reassessment of how it is managed. We do have some concerns that, in a system that does not give schemes an opportunity to address an Amber rating, there is a real risk that the green rating becomes too dominant and may mask a range of addressable performance issues. We do not consider this beneficial to the successful operation of the framework, and suggest that those with an Amber rating should have a means of improving it.

Question 33: Do you agree with our proposed actions and timings for firms with arrangements rated amber or red? If not, what alternative approach would you suggest?

We have covered our views on how those schemes with a Red rating should be handled in the following question.

For those with an Amber assessment, we are of the view that this is a high bar, and that the requirement that schemes set out a clear plan to address it is appropriate.

However, we do not agree with the proposal that schemes with an Amber rating would only be downgraded to Red on the fourth year of inaction, or of ineffective action. The paper suggests that an Amber rating would be applied where there is an expectation that concerns should be addressed within a reasonable timeframe, and we would suggest that four years is too long a period for ICGs to not be satisfied that improvements have, or can, been made.

We strongly recommend that consideration is given to reducing this timeframe by at least one year. Given the strong view held by the pension industry that an Amber rating will have severe commercial repercussions for schemes, we cannot see how members in a scheme that has been Amber for up to four years are being well served. We would suggest that the Amber rating should be designed to target schemes that can make changes, and so any continued failure to do so should be suitably addressed.

Question 34: Do you think that we should require firms to transfer savers out of red-rated arrangements, subject to enabling legislative changes? What are the costs associated with the proposed actions and are they proportionate? If you don't agree with our proposed actions, what would you suggest?

We support legislative changes to enable this. A provider that is not offering value for money to members, and where an ICG does not believe that this cannot be addressed within a reasonable timeframe, may be breach of its obligations under the Consumer Duty. As schemes in this situation would effectively become legacy schemes, it is essential that the pots of the members within it have the same protections as other pension savers.

We would also like to flag that there is the possibility of a bulk transfer without member consent in trust-based schemes, and so unless the discrepancy is addressed, there remains a risk of regulatory arbitrage. Schemes operating under contract-based rules leave themselves vulnerable to legal action, and may struggle to gain consent from individual savers.

We therefore support this being progressed as part of the forthcoming Pensions Bill, so that the VfM framework can be implemented across all in-scope pension on the same basis from the outset.