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Pensions & Private Capital Expert Panel

Interim Report

September 2024

Pensions and Private Capital Expert Panel engagement

18
Senior industry leaders on the Expert Panel

12
Technical Expert Group meetings

Over 40
Firms represented in the Technical Expert Group

Over 100
Targeted meetings

6
Industry trade associations and stakeholders represented **ABI, BVCA, CoLC, IA, PLSA, TheCityUK**

Over 10
Meetings with Government and regulatory stakeholders; **DWP, HMT, FCA, TPR**

£2.5trn
ABI and PLSA members safeguard a total of £2.5trn worth of assets on behalf of their members

£20.1bn
Private capital backed UK businesses to the tune of £20.1 billion

Foreword

Kerry Baldwin
Chair, Pensions & Private Capital Expert Panel

I was asked to carry out this review to find solutions which address the reasons behind UK DC pensions not investing more of their assets into private capital funds. Doing so can in turn drive investment into high growth innovative companies, benefitting both society and productivity of the UK at the same time as UK pension savers.

There have long been concerns that individual UK DC pension savers could be benefitting from greater returns upon retirement with a more diversified pension investment strategy. This is evident in a number of other countries, which have a long-established history of pension funds investing in private capital, including venture capital.

The forming of the Pensions and Private Capital Expert Panel in February 2024 captured the momentum of the commitments made by the signatories of the Mansion House Compact and the Investment Compact for Venture Capital and Growth Equity. The work and progress we have collectively made demonstrates a real commitment by those involved to make a difference and work collaboratively together to find solutions to the existing barriers.

The considerable body of work that had already taken place, most notably by the Productive Finance Working Group, laid the groundwork of the Panel's understanding of the challenges for DC pension schemes investing in private equity and venture capital. We have looked to build on that work with a renewed focus on developing solutions which can be implemented quickly.

Th challenge ahead is considerable – 16 times more capital from pensions around the world goes into UK private capital than from British pension funds. The UK is facing a real crisis in retirement unless we act – the PLSA estimates that only 35% of households saving into a DC pension will meet the 'moderate' level of retirement income, as set out in the Retirement Living Standards. Growing companies also

Foreword

need investment to meet their full potential and ensure the UK can achieve the growth targets needed to deliver the living standards people expect. As Managing Partner and co-founder of a venture capital firm and investing in deep tech for over 25 years, I see the challenge ambitious companies have in attracting investment required to scale and remain in the UK, and how often they need to go abroad to secure growth funding.

However, the opportunity is considerable too. Investors in private capital have earned up to 41% more than an equivalent public equity investment since 2014. The UK has one of the most innovative early-stage venture capital sectors in the world. The new Labour Government has shown not only to be prioritising UK growth, but to be doing so with some urgency and with a very clear ambition for the UK pension sector to play a key role. I have formed the view that more action from Government regulators, and the industries themselves. could make a real impact. This report also sets out some priorities for other stakeholders, and some commitments on how the BVCA plans to take these issues forward.

This report also begins the process of helping DC pension schemes and the private capital industry understand each other better – a theme the Expert Panel noted is particularly important, and on which there will be a continued focus. There will be further work on the key areas in the coming months, and a final report will be published in 2025.

This initiative has been a significant undertaking. Across the Expert Panel, the Technical Expert Group, and numerous meetings with stakeholders, we have engaged leaders across pensions, private capital, and the professional services industries that support them. We've been especially pleased to work in partnership with the Pensions & Lifetime Savings Association and Association of British Insurers, whose members safeguard £2.5 trillion of assets on behalf of UK pension savers. Since the project launched in February, there have been over 100 meetings and numerous individual expert discussions. I am grateful to everyone who has been so generous with their time and expertise, bringing positive collaboration to work through recommendations for solutions.

These initial recommendations are aimed at bridging the gap between two industries, in the interests of both. There is much work still to be done, but with momentum, and a commitment to improving the retirement prospects for pension savers, I believe they will have a significant impact.

Acknowledgments

I'd like to thank everyone who has generously given up their valuable time to help us fully explore the complex issues for both DC pensions and private capital firms. In particular, the 18 Expert Panel members, whose insights and advice have been particularly helpful to me, as well as the 60 plus members of the Technical Expert Group and PwC, who have effectively been 'on call' for the past few months!

I also wish to thank our partners in this initiative and the wider work around the Mansion House Forum, especially the PLSA, ABI and City of London Corporation. They have proven to me the value working together on complicated issues, and I hope this positive engagement can continue well beyond the scope of this work. I've also been especially grateful to those in DWP, HM Treasury, DBT, TPR and FCA, who have engaged positively with us, and demonstrated how seriously these issues are taken within Government and regulators.

Finally, I'd like to note my thanks to the entire BVCA team, who have not only coordinated the entire project and ensured the report is published, but who have worked hard for many years to raise awareness of the need for more DC investment in private capital.

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Kerry Baldwin
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John Chilman
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Andy Gregory
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Chief Financial Officer, Molten Ventures


Tom Wrenn
Managing Partner, ECI

Executive summary

Executive summary

Shortly after it came into office, the Government set up a pensions review, to boost investment and increase pension pots. The Government estimates that an investment shift could deliver £8 billion of new productive investment into the UK economy. This interim report is seeking to provide solutions for how DC schemes can meet this challenge.

The public policy challenges

The new UK Government has demonstrated a strong commitment to addressing the retirement prospects of savers in DC pension schemes, and to boosting investment in high growth businesses to secure sustainable economic growth.

The DC pensions industry and the private capital industry, and in particular the venture capital and growth equity sectors within it, meet at the overlapping point between these two public policy challenges. Through collaboration, they can find solutions for both.

With a £2.5 trillion pension market, of which DC pensions represent a total of £1.4trn of assets, there are millions of UK savers on whose behalf the pensions industry manages capital. On the current trajectory it is likely that DC assets will grow significantly in the coming decades, particularly if contributions increase. The introduction of auto-enrolment into DC pensions has meant that DC Master Trusts have largely replaced DB pensions as the most common workplace savings vehicle. However, the different structure and relationship between the scheme and the saver has also meant a decline in pension fund investment into private capital in the UK, and a growing recognition of the inadequacy of DC pension pots.

Investment in private capital, such as venture capital and growth equity, can boost retirement prospects for pension savers, by investing in high growth businesses across the UK. Recent data from the British Business Bank demonstrates that private equity and venture capital funds produce the highest returns on average when comparing UK alternative asset classes. Yet, there is scope to do more in this area. At present, international pension schemes invest approximately 16 times as much in UK private capital as UK schemes do. In 2022, UK-managed venture capital and growth equity funds received approximately £432m from international pension funds, whereas UK pension fund investment accounted for only £48m.This demonstrates that the opportunities exist, which could have an impact on the returns to pension savers.

Working together and making progress

Both the DC pensions industry and the private capital industry have committed to working together to develop solutions to the issues which currently prevent these opportunities being realised.

The commitment is underpinned by two significant statements of intent: the Mansion House Compact, initiated in July 2023, has brought together 11 of the UK's largest DC pension providers, who have agreed to invest 5% of their default funds under management to unlisted equities by 2030. Separately, the Investment Compact for Venture Capital & Growth Equity has been signed by over 100 venture capital and growth equity firms who have committed to working with the pensions industry to clear the pathways to that investment. These commitments have been the focus of an industry-led collaborative project which has been underway since the start of 2024 - this is the interim report on the progress to date.

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The Expert Panel

The Pensions & Private Capital Expert Panel ('Expert Panel'), which is made up of senior representatives of both the DC pensions and private capital industries, has led this work. Supported by the BVCA, ABI and PLSA, the participants began by developing a shared understanding of the existing barriers for DC pension schemes that wish to invest in venture capital and growth capital in the UK- this was published in PwC's Report to the Expert Panel in February 2024.

The Panel felt that the priority for the project should be on the default funds of DC Master Trusts. Currently, more than 90% of those who are automatically enrolled into a pension scheme remain within the scheme's default fund. A survey performed by PPI revealed that amongst adults with at least one active DC pension, over half (c.51%) have a 'low' or 'very low' engagement level. The Panel therefore acknowledged that solutions focused on either 'self select' funds, or aimed at incentivising individual saver behaviour, may be of limited impact. The discussion therefore focused principally on private capital allocations within DC Master Trust default funds.

From this starting point, the Expert Panel requested further analysis from a Technical Expert Group, drawn from both the pensions and private capital industries and the advisory communities which operate at the heart of them. In the past nine months, contributors from over 40 firms have participated in more than 100 meetings.

As a result of this programme of work, the Expert Panel is now setting out its interim recommendations for a series of structural, technical and wider policy options designed to contribute towards better outcomes for UK savers in DC pension schemes and greater investment in high growth businesses in the UK.
The recommendations are designed to assist industry, policymakers, regulators and other stakeholders to develop solutions to the public policy challenges of enhanced pension prospects and improved economic growth.

An ambitious programme

As a result of the collaboration and volume of work undertaken to date, the Expert Panel is confident that the UK can deliver an ambitious programme to address these challenges.

There are different dimensions to this programme:

- **Better understanding:** developing a better understanding between the DC pensions and private capital industries is a pre-requisite to developing appropriate solutions to the public policy challenges. Already there has been significant progress in this area.

- **Removing friction:** developing custom and practice in both industries and adapting arrangements within current legal and other frameworks will make it easier for the two industries to work together.

- **Regulatory change:** an industry-led approach, as exemplified by the Compacts and the Expert Panel process, can deliver improved outcomes, but it is clear that certain regulatory arrangements will constrain the UK's ability to maximise the opportunities that have been identified.

New structures: as the shared industry understanding develops, it may be that new vehicles can be created to realise the full potential which the industries, working together, can deliver.

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Other activity

The Expert Panel's work is not operating in a vacuum and the participants have been encouraged to see the ways in which market players have announced significant initiatives to address the shared challenges and how government institutions, such as the British Business Bank are actively engaging in this area. Through engagement such as via the Mansion House Forum, the BVCA's UK Pension Summit and other industry conferences supported by the PLSA, ABI, BVCA, the City of London Corporation and others, the industries are committed to remaining aligned on objectives and working collaboratively. In addition, the newly elected Government has commenced a Pensions Review, to consider issues affecting DC and the Local Government Pension Scheme.

Key themes and recommendations

The Expert Panel established at an early stage that the key issues should be addressed under a series of themes:

- Investment case & transparency;
- Market Infrastructure;
- Liquidity; and
- Evolution of the wider pensions market

The investment case & transparency

The Expert Panel recognised the need to build mutual understanding across the pensions and private capital industries to build confidence among DC decision-makers of the potential benefits of investing in private capital funds. It was evident that the private capital industry needed to demonstrate the value for pension schemes of investing in private capital funds. This report includes the latest evidence on the returns data that global investors have generated from private capital fund investments.

In order to build understanding, the report includes dedicated explainers on different elements of private capital funds and provides examples of best practice and industry standards in relation to transparency, reporting and due diligence.

The report emphasises the importance of pensions schemes being able to prioritise long-term risk-adjusted net returns, and that the implementation of a Value for Money framework needs to take priority. It includes recommendations around the considerations that the FCA, DWP and TPR should have in mind when developing the framework.

The Expert Panel also considered the issue of cost transparency, and how this could be improved throughout the investment chain. It sets out a recommendation for industry and regulators on improving consistency, and also that industry should develop a model Request for Proposal. In addition, on pricing, the panel explored what developments there have been in the market, and examples of how schemes can approach this challenge.

Pricing and fees are perceived by many as presenting challenges to DC schemes. The report explores the specific challenges when it comes to pricing private capital fairly within DC schemes, and outlines how some DC providers are addressing them. The Report also considers the issue of fees, and the extent to which fee structures pose

Executive summary

challenges. The Expert Panel recommends further consideration of this area across both pension and private capital to benefit pension savers.

The Expert Panel also considered the role effective Government leadership can have through Government-supported initiatives to support UK pension investment into private capital funds. The report considers the success of existing schemes, such as the French 'Tibi' scheme, and outlines key considerations for the UK Government.

Market Infrastructure

The Long Term Asset Fund (LTAF) was launched by the FCA to enable more pension investment into illiquid investments and an increasing number are being brought to market. To improve the current market infrastructure and ensure greater use of the LTAF as an effective investment vehicle, the Expert Panel recommends that the FCA should make targeted changes to the relevant regulations so that investor access is not unduly restricted and more LTAFs are encouraged to come to market, to facilitate scale.

The Expert Panel considered the prominent role of life insurance platforms in the DC landscape, and how the infrastructure around them, including the regulation, is often better suited to a 'daily dealing' environment.

The report recommends amendments to the "permitted links" rules to widen life platforms' investment options and provide broader investment options for DC default schemes that use them to facilitate greater investment into private capital. It also calls for more action by platform providers to increase the private capital investment options available to DC pension schemes.

Liquidity

Managing liquidity to meet the needs of members is an important consideration for DC pension schemes investing in private capital funds. The Expert Panel concluded that day-to-day management of liquidity is not a concern for most Master Trusts, given their scale and rate of growth, but recognised the potential impact of bulk transfers or one- off liquidity events. Though rare, this may act as a disincentive for DC pension schemes to invest in private capital products.

To provide additional comfort for trustees, the report recommends the regulator considers further guidance on this, or whether new rules are needed to manage this risk.

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Wider UK pensions evolution

This report sets out the Expert Panel's considerations on the opportunity for 'to and through' style investing to replace 'lifestyling' strategies that have typically been used in the past. The Expert Panel explores the potential role that alternative risk pooling models, such as Collective Defined Contribution, could play as a long-term solution to addressing the current barriers to investment into private capital, and recommends that the Government continues to explore this.

While the recommendations set out in this report are focused primarily on DC default pension schemes, the UK pensions system is also formed of Defined Benefit and Local Government pensions schemes which are considered here as part of the broader pensions context.

Focus on policy development

The recommendations set out in this report aim to provide policymakers with a clear roadmap to facilitate meaningful change, and a pathway to supporting DC schemes in achieving their commitments set out in the Mansion House Compact.

While some areas in the Report are most relevant to specific audiences, building a mutual understanding across both the pensions and private capital industries, alongside the effective role that policymakers can have to achieve a stronger, more effective partnership, is crucial.

Recommendations

The Expert Panel makes the following recommendations.

1

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.

So far, DC pensions have primarily focussed on a low cost offering with less emphasis on overall returns and little comparison of returns between different providers.

Progress on the 'Value for Money' framework is already subject to consultation, however we believe that prioritising this objective can lead to meaningful change in the approach taken by the market in the coming years.

2

Consistent cost disclosure requirements should be applied across the investment ecosystem.

DC pensions need to have confidence that they have full oversight of costs. Private capital firms have also explained that they need clarity on what information pension investors need.

There are a number of existing cost disclosure requirements and frameworks – more work needs to be done to ensure they are consistent and useful. When developing or revising reporting rules, regulators should seek to ensure that there is consistency throughout the investment chain. This would give greater reassurance and improve the flow of information and capital.

3

The private capital and pensions industries should work together together to develop a model Request for Proposal.

DC schemes can find it challenging to compare private capital investment opportunities firstly with other investment opportunities and secondly between different private capital opportunities.

To ensure that private capital fund managers understand what DC schemes are seeking, and that DC decision-makers are able to compare like-for-like information on investment products, the private capital and pensions industries should work together to develop a model RfP, and/or guidance.

4

DC schemes, platforms and advisers should use quarterly private capital valuations, alongside appropriate governance for unusual liquidity events, to ensure fairness between members in unit pricing.

Calculating a daily price for unlisted assets like private capital investments requires thought and a degree of judgement. Nonetheless, firms can and do already provide daily prices for illiquids in various contexts.

Relevant learnings from that experience which the Expert Panel encourages industry to consider more widely include that the use of latest available quarterly valuations, alongside appropriate governance and override powers for unusual scenarios, can maintain fairness between scheme members, and that more regular company valuations may not be required.

Recommendations

The Expert Panel makes the following recommendations.

5

All parties should consider in detail how far new and alternative approaches to fee structures might be made to work in savers' interests.

UK DC pensions have different perspectives and considerations on fees compared to other global investors, due in part to features of the UK DC system.

There are operational and commercial reasons why UK providers sometimes face challenges with standard private capital fee structures.

Commercial discussions are the appropriate way for private capital firms and pension providers to address those challenges and secure the best risk-adjusted net returns for savers. The market is already developing as a result of better understanding of both private capital and pension investment approaches.

This report suggests considerations to assist with this.

6

As the Government explores the creation of new vehicles or schemes to facilitate pensions investment in high growth companies, it should draw learnings from domestic and overseas precedents (including the French Tibi scheme).

Finding investment opportunities in innovative and emerging sectors can be challenging.

There are a number of successful example of overseas initiatives that have generated significant investment in emerging sectors and stimulated growth, e.g. the French Tibi scheme.

The design of UK vehicles or schemes should consider overseas learnings and ensure that their features are tailored to the UK market, building also on existing domestic initiatives including the LIFTS scheme.

7

The FCA should consider making targeted changes to the relevant regulations so that investor access is not unduly restricted and more LTAFs are encouraged to come to market.

The LTAF has been successful in generating momentum and interest in private capital investments amongst UK DC schemes, and a number of LTAFs have now been launched.

The FCA should now make targeted changes to the relevant regulations so that investor access is not unduly restricted and to encourage more LTAFs to come to market (and drive scale).

This would help optimise the opportunity presented by LTAFs and result in an acceleration in the number and scale of LTAFs.

The Expert Panel welcomes the FCA's consultation on the NURS rules, launched on 6 September.

8

The FCA should review and amend the permitted links rules.

Life insurance platforms administer a significant proportion of both DC members and DC assets.

Previous amendments to the permitted links rules have enabled platforms to offer more private capital opportunities to DC pension schemes.

Panel believes further changes could accelerate this and recommends the FCA consider:

(i) excluding defaults from the permitted links rules; or

(ii) including certain common private capital fund structures explicitly as conditional permitted links, and exempting them from the 35% cap on illiquid assets.

Recommendations

The Expert Panel makes the following recommendations.

9

Life insurance platform providers should continue to expand private capital options for DC schemes.

Previous rule changes have meant that life platforms are now able to offer more options to DC pension schemes, and providers have begun offering more illiquid investment structures such as multi-private markets LTAFs.

However, the Expert Panel noted that progress could be quicker, given the clear increase in demand from DC schemes.

Life insurance platforms should act with urgency to address any operational barriers that are making private capital investments challenging, and offer more private capital opportunities to DC schemes.

10

Regulators should work with industry to provide reassurance, and updated guidance, on their liquidity expectations for how DC schemes should handle stress events and their impact on liquidity.

Industry feedback suggests that the volume of deposits in most large Master Trusts has ensured the day-to-day management of liquidity has not been a concern.

However, it was noted by the Expert Panel that as exposure to private capital and illiquid assets increases, certain material one off events (e.g. market consolidation), and managing the impact and consequences on available liquidity may deter schemes from having a higher exposure to illiquid assets.

Additional guidance from regulators could help address this and provide comfort to pension providers.

11

DC schemes consider the role of 'to and through' investing, with a view to keeping savers invested in private capital investments for longer periods of time.

To date, 'lifestyling' investment strategies have reduced exposure to growth assets approaching and at retirement.

For those with pots over a certain size there are potential benefits from remaining invested in growth assets for longer and into retirement, and some providers are already making this change.

Alongside the need for all DC schemes to provide decumulation options this shift in approach could over a short period of time mean a greater proportion of funds invested in growth assets, both improving returns and generating investment in the real economy.

12

Industry and Government should work together to determine how risk can be better pooled in DC structures, in the interests of savers. In particular, CDC schemes should continue to be explored.

The Expert Panel encourages more consideration of how DC savers can benefit from risk pooling in investments.

In particular, the Government should continue to progress the benefits of a full regulatory framework for Collective Defined Contribution. This should take into account the success of asset pooling in overseas pension systems.

Guides

Private Capital Explained

Maximising the potential of the market infrastructure

To and Through

Private capital unit pricing

Liquidity management

Overseas insights

The investment case and transparency

The investment case and transparency: overview

The Expert Panel felt that further progress was needed in clarifying and fostering wider understanding of the investment case for UK DC allocations to private capital funds. The case in favour of including private capital allocations in a DC portfolio rests not only on the industry's net returns track record, but also on private capital allocations' impact on portfolio diversification and risk-adjusted net returns, the potential role for the asset class in furthering investors' sustainability objectives, and the impact of private capital support on businesses' operations and the wider economy. Ensuring DC schemes can fully see, measure and analyse all of these potential benefits, in relation to individual opportunities and the asset class as a whole, is closely connected to information flows and reporting. This section of the report therefore sets out some key aspects of the wider investment case for private capital and explains some key considerations and features of the industry that DC investors should focus on when approaching private capital investment. It also draws on this analysis, and industry discussions, to make recommendations for industry and policymakers around clarity and consistency in information flows, the Value for Money framework, pricing, fees and the opportunities for Government to facilitate investment in innovative high-growth companies.

Barriers to investment
(Report to the Pensions & Private Capital Expert Panel – February 2024)

The Expert Panel recognised the need to build mutual understanding across the pensions and private capital industries and the importance of transparency on investment performance, costs and charges for DC pension funds. The Expert Panel and Technical Expert Group explored several barriers as part of a dedicated section on the Investment Case and Transparency which focused specifically on:

Investment case – providing a clear case and widespread understanding of the wider value of investing into private capital funds and the returns that can be generated as part of a diversified investment portfolio.

Transparency – providing a common understanding around the reporting requirements and decision-making practices in the private capital industry particularly in relation to fees and how the development of the Value for Money framework should consider investments into private capital funds.

Progress so far
(Pensions & Private Capital Expert Panel – Interim Report - September 2024)

This interim report provides the following explainers and recommendations to address these barriers:

Investment case –outlining thekey pillars of the investment case for private capital and the wider value private capital funds can bring as part of a diversified investment portfolio.

Transparency – recommendations in relation to the Value for Money framework and fostering further clarity around information flows, especially as regards investment costs.

Risk profile – considerations for industry in developing daily pricing and fee arrangements to support successful DC investment in private capital funds, and the role of Government support.

Next steps
(Pensions & Private Capital Expert Panel – Final Report & Recommendations – Q1 2025)

Both the private capital and pensions industries remain committed to establishing a strong partnership to help improve outcomes for pension savers and support the economy, as demonstrated by the ABI Mansion House Progress Update.

Building on the work of the interim report, the final report of the Expert Panel will continue to assess how the pensions and private capital industries can continue to build mutual understanding of the key features of both industries.

It will also do more work tto help facilitate appropriate discussions on fees and support market development: including on how the Value for Money framework can be successful in changing how the industry approaches short term costs.

The investment case and transparency

The investment case

The investment case: industry track record

There is extensive evidence and data showing private capital industry has a track record of delivering strong returns to investors, net of fees. This is particularly notable when compared to public markets.

Private capital investment performance[1]

The BVCA Performance Measurement Survey, in association with PwC, shows that UK managed private equity and venture capital funds have collectively achieved an internal rate of return (IRR) of 14.5 p.a. since 1980. Looking at all suitably mature funds from the 2014 vintage onwards, the collective since inception IRR is 17.8% and the Total Value to Paid-in multiple (TVPI) of 1.82x. The money multiple metric shows that these funds would have almost doubled their invested capital, had all their assets been realised as at 31 December 2023 net of all costs and fees.

There is a wide dispersion in returns at the fund level. Manager selection is critical, as is having the scale to invest in a broad range of funds to diversify within the venture capital asset class.

Performance relative to public markets

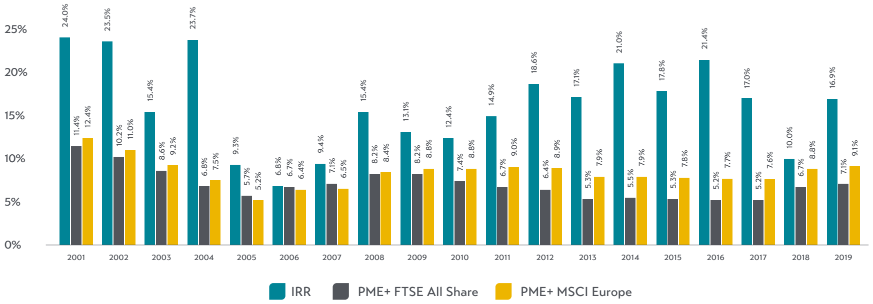
Private equity and venture capital is an asset class with a long-term investment horizon and a history of delivering returns in excess of those achieved by the public markets. The simplest illustration of this is to compare the 15% ten-year horizon return for funds managed by the BVCA members to the equivalent annualised return of 5.3% and 7.5% for the FTSE All Share Index and the MSCI Europe Index respectively.

A Public Market Equivalent (PME) analysis is an important part of enabling investors to understand the relative returns generated by private capital. The PME+ analysis shown below demonstrates how private capital funds in the performance Measurement Survey dataset have collectively outperformed the public market as represented by the FTSE All Share Index and MSCI Europe Index every year since 2001.

Further details of this analysis can be found in the BVCA Performance Measurement Survey 2023. In addition to the data presented here, there is a range of academic and other literature exploring the long-term performance of private capital, summarised here.

[1]No returns are guaranteed, and pension schemes should ensure they seek professional investment advice and are fully aware of the risks associated with any investment.

Since Inception IRR and PME+ by vintage year



Spotlight: venture capital and growth equity

Venture capital funds invest in earlier stage companies with a higher failure rate, where returns are driven by a smaller cohort of very high performing companies within the portfolio, whereas growth equity invests in established companies with a much lower failure rate, but a flatter returns profile.

This is reflected in the returns profile at the fund level, where the top quartile of VC fund performance make up the majority of the returns in the asset class. This makes diversification important. In growth equity there is a narrower range of more consistent across the asset class.

Recent data from the British Business Bank (UK Venture Capital Financial Returns 2023 Report) demonstrates that private equity funds and VC produce the highest returns on average when comparing alternative asset classes, though the top performing VC funds can generate higher gains. While UK private equity funds generate a higher median TPVI (1.78) than UK VC funds (1.67) across 2002-2018 vintages, the upper quartile performance of VC funds was higher than for any other UK alternative asset class.

The investment case: greater diversification

Fast-growing companies across sectors are increasingly remaining in private ownership for longer periods before being acquired or listing on an exchange. This means the investment case for venture capital and growth equity, as well as wider private capital funds, can be expressed in terms of its portfolio diversification benefits alongside its absolute returns potential.

Exposure to the high growth companies backed by venture and growth equity funds is important for diversification

An optimal investment strategy should allow DC schemes to gain exposure to the full range of fast-growing private companies. Accessing these companies provides a source of returns and portfolio diversification.

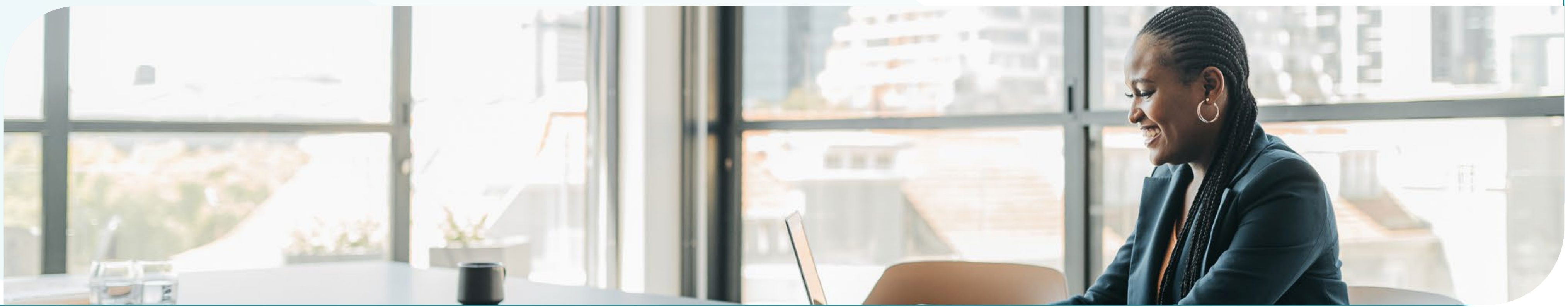
As an asset class, the risks and returns of private capital are distinct to those of other classes, including listed equities. A broad portfolio of distinct asset classes provides diversification which is a fundamental tenet of portfolio theory, where the performance over time of one asset class will offset the performance of another. In a balanced portfolio the returns achieved should be higher and bring less volatility.

The diversification impact of private capital investment has also taken on greater significance as the number of companies listed on the public markets has dropped, and companies are staying private for longer and using other sources of capital to fund their development. This is particularly the case for innovative high growth companies, which DC investors can access through venture capital and growth equity funds.

While the private capital market is a small fraction of the public equity market (estimated to be around $100tn), globally AUM in private capital has grown from around $2tn in 2013 to around $8tn in 2023, highlighting its increasingly important role in the global economy. We anticipate that the proportion of privately held companies will continue to grow.

According to Preqin and S&P Global Market Intelligence data as of 1 December 2023, global private capital dry powder (capital committed to private capital funds but awaiting deployment into companies) was at a record $2.6tn. This capital is available for investment in businesses in the next five years or so, providing additional support to help businesses grow. This demonstrates how venture capital, growth equity and private capital funds have an important role to play in investors' portfolios, by enabling them to access this growing segment of the market that is not correlated to public markets and therefore provides additional diversification for pension portfolios.

A summary of the academic evidence on the benefits of diversification to improve risk adjusted returns can be found in section 5 of the BVCA research note here.



The investment case: greater diversification

Funding innovative companies across the UK: examples of private capital backed companies in a diverse range of growth sectors

Micrima

Bristol

ACF Investors (venture capital)

Micrima, a Bristol University spin-out, was founded in 2006 to develop and commercialise a non-invasive breast imaging system using low frequency, nonionising radio-wave (RADAR) technology. Breast cancer is the most common cancer in women of all ages globally and earlystage detection has a significant, positive impact on survival rates. Micrima's hardware and software patents will enable breast screening to be undertaken earlier, more frequently, at lower cost and in more locations. The company has been supported by ACF Investors since 2012. Their support has helped it develop the hardware and software from prototype stage, through extensive hospital trials and is now in use with Key Opinion Leaders at 5 sites across the UK and Continental Europe.

Skyscanner

Edinburgh

Scottish Equity Partners (SEP) (growth equity)

Skyscanner is an online travel technology established in 2002 and headquartered in Edinburgh. Scottish Equity Partners (SEP), which first invested in 2016, supported the company's internationalisation through M&A activity and the opening of 10 global offices across the US, Europe and Asia. SEP also helped the company with its strategic development and growth, and led a number of financing events, including investment from Sequoia and Baillie Gifford. SEP played a lead role in the company's subsequent exit to NASDAQ-listed Trip.com for £1.5 billion. Skyscanner's headcount went from 30 to 800+ during SEP's involvement, and the company has continued to grow strongly.

altia.

Nottingham

NorthEdge (growth equity)

Altia is a leading global provider of intelligence and investigation software, which develops specialist software for government departments and law enforcement agencies in countries including the UK, Canada and Australia. The business, headquartered in Nottingham, develops software that enables investigation teams and police forces globally to automate processes, reducing time and financial resources spent on investigations. This includes digital casefiles, business workflow management and financial data analysis through its Altia HQ platform. NorthEdge has supported Altia since 2020, when it completed a primary MBO into the business, and has helped to build out the leadership team, deliver organic growth and enhance the technology, alongside supporting Altia to expand into additional international territories and complete a number of strategic bolt-on acquisitions – enabling the business to access new markets, bring complementary technologies onto the Altia platform and support additional customers.

The investment case: greater diversification

Funding innovative companies across the UK: ase studies of the value of diversifying investment into private capital funds

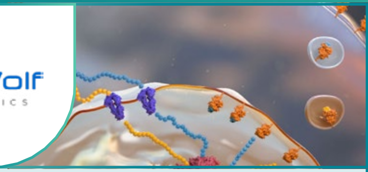
Revolut

London

Seedcamp (venture capital)

Revolut is a British Fintech company offering both personal and business Banking services. In 2015 Revolut launched in the UK, offering money transfer and exchange. Today, their customers around the world use dozens of Revolut's innovative products to make more than 100 million transactions a month. Across personal and business accounts, they help customers improve their financial health, give them more control, and connect people seamlessly across the world. The business has been supported by Seedcamp, among others, since April 2015, helping its headcount go from 5 to more than 10,000 employees across the globe.

GreyWolf Therapeutics



Oxford

Intermediate Capital Group (ICG) (growth equity)

Grey Wolf Therapeutics is developing novel drugs to treat cancer and autoimmune disease. Formed in 2017 by two biotech entrepreneurs (Peter Joyce and Tom McCarthy) Grey Wolf has attracted over £100m in financing to date with Intermediate Capital Group leading the most recent round. Since its inception the company has advanced its oncology drug into early clinical trials, expanded its pipeline and therapeutic reach, and has attracted investment from blue-chip life science and institutional investors. In late 2022 they secured a clinical supply agreement with Regeneron and in 2023 attracted strategic investment from Pfizer Ventures. Grey Wolf is entering a period of significant growth as they advance their pipeline through clinical trials. If successful, their approach could alter the treatment paradigm for millions of patients globally.

The investment case: active ownership drives returns

Private capital firms drive returns through "active ownership". This describes the intense activity firms undertake to help portfolio companies grow during a fund's ownership tenure. This is very different to the "active management" of liquid portfolios, which focuses on monitoring and altering the balance of a portfolio's exposures. The size of ownership stakes taken by private capital funds gives the firm influence over investee companies. Private capital firms use that influence to create returns for investors over the long term.

Private capital's approach to governance and incentives for entrepreneurs and management teams

Venture capital funds take meaningful minority stakes in early-stage companies, working with founders and entrepreneurs to grow and develop the businesses through rounds of investment. There are usually several venture investors in a company who together can influence significant decisions on strategy and the appropriate management at various stages of growth. Venture capital funds also secure certain influential legal rights such as vetos, and firms provide additional support in multiple ways, such as access to networks, talent acquisition & strategy development. Growth equity funds also provide these kinds of non-financial support but will often hold larger minority or majority positions. The active ownership model of both not only provides strong incentives to monitor management but also delivers influence or control over portfolio companies, which is exercised in different ways:

Access to detailed company information around audit, financial metrics, company strategy and sustainability performance: : the concentration of ownership gives private capital firms greater power to obtain information necessary to support their monitoring and evaluation of progress and performance (relative to owning small percentages of listed companies, where influence over the issuer is small and information flow is necessarily tightly controlled and limited by the rules governing public capital market disclosures).

Governance improvements: Private capital firms gain and exert influence over the boards of the private companies their funds support. Private capital portfolio company boards also tend to be much more hands-on and likely to shape strategy and culture of the company. This contrasts with public companies whose boards usually focus on supervision, providing support to management with less focus on day-to-day operations. Depending on the size of the fund's ownership position, private capital firms may be able to select a new CEO and senior company management. Growth equity (typically) and venture capital firms (often) nominate executives to board positions in portfolio companies, depending on the size of the equity stake, to ensure the firm has the levers to support founders and senior teams to drive growth and improve governance procedures.

Management incentives and focus: Private capital firms usually focus on the compensation of and incentives for founders, entrepreneurs and senior company executives, in order to fully align their long-term interests with those of the fund and its investors in growing the company towards an ultimate exit (in the same way the firm's interests are aligned towards the same goal via carried interest (see "Private capital explained" below). The bulk of compensation is often paid upon exit via the exercise of stock options – this is different from CEOs of public companies, who can be rewarded for shorter term performance based on stock price movements. For private companies, intermediate valuations do not reflect observable prices on an exchange, which means that intermediate value for shareholders is typically not a distraction for management, which instead can focus on maximizing the long-term value in anticipation of an exit. The duration of a typical private capital investment is 3-7 years (although this can vary with investment stage) — much longer than the quarterly earnings cycle of listed companies. This longer horizon removes incentives towards maximising short-term accounting performance or limiting capital expenditures or R&D spend that should ultimately increase the company's value. At the same time, venture capital firms typically introduce long-term incentives for the management teams of investee companies, in the form of share options under the Enterprise Management Incentive (EMI) schemes, which focus management on growth and driving value creation (which in turn drives returns for investors).

The investment case: active ownership creates value

Private capital investment can deliver benefits for profitability, productivity and UK growth as a whole.

Profitability and productivity

Profitability: Academic research demonstrates a positive impact of private capital on profitability, and productivity of PE/ VC backed companies. Non-financial results of PE /VC involvement such as innovation, product offering, better management practices, workplace safety are also largely positive.

Productivity: Academic research provides evidence that private capital investment has a positive effect on productivity at target firms and across entire industries through spillover effects. For example, one study focusing on the UK market, estimate total factor productivity in PE-backed (including growth equity) business to increase by around 4% from pre- to post-buyout period (up to four years before and after initial investment) relative to control firms. Similarly, labour productivity rises by around 5% relative to the control group from pre- to post-buyout. There are other studies that also demonstrate this (see below). The impact of venture capital on business productivity is likely to be most keenly felt in the new and growing businesses and the productivity tools invented and commercialised by them.

Research by Oxford Economics (Innovation Nation 2020), showed that VC backed businesses invest in more productive sectors (eg technology) at a much greater rate than the wider economy. This leads to VC-backed businesses collectively contributing 60% more GDP per worker than the UK private sector average.

Further studies include Lavery and Wilson (2022), Davis, Haltinger, Handley Lipsius, Lerner and Miranda (2019) or Gulliver and Jiang (2020) with wider research on this topic summarized here.

The investment case: supporting long-term sustainability objectives

Private capital firms' active ownership model and degree of influence over portfolio companies gives them effective levers to drive sustainability improvements. This adds a powerful component to the investment case, for investors seeking to drive and evidence tangible environmental and social change and impact. In addition, ESG reporting to evidence this is well adopted and advancing.

Active ownership drives sustainability improvements as part of value creation

Private capital fund investment supports investors' sustainability objectives because the industry's active ownership model both empowers and incentivises private capital firms to implement sustainability improvements in portfolio companies, creating positive impact on society and the environment.

Private capital's fundamental objective is to maximise value and achieve the highest possible returns for investors on exit several years later, which means firms must anticipate potential future buyers' requirements several years ahead. In a world where investors' focus on sustainability issues is set only to increase, this means private capital firms are highly incentivised to use the levers provided by their funds' concentrated ownership positions to improve portfolio companies' sustainability performance.

Private capital funds also act as a conduit for investors to support the innovative, early-stage businesses that are developing solutions to some of the most pressing environmental and social challenges faced by the UK, and the world. These can offer compelling stories for DC schemes seeking to drive members' engagement with where their pensions are invested – some examples of private capital backed companies with exciting social or environmental impact are included on the following page.

ESG reporting

Investing responsibly and creating positive social or environmental impact is a key consideration for both pension schemes and the private capital industry.

Private capital firms understand the value and importance of collecting sustainability related data to track performance and for reporting purposes. However, this is nascent and most acute at the earlier stage of a company's development (SMEs), where their entry into a private capital fund portfolio will often be their first encounter with sustainability-related reporting requirements. Private capital firms' active ownership positions help drive ESG improvements within portfolio companies and support them to achieve sustainability aims.

Significant progress is being made to standardise ESG reporting disclosures and templates, with several industry-led initiatives having been developed (see opposite). These initiatives, some of which are specifically tailored to the venture capital industry, have been developed following extensive engagement with stakeholders, to help businesses navigate the current reporting requirements and articulate the significant contribution they make on issues such as net zero, cyber security and DEI.

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ESG_VC Measurement Framework: Developed by industry bodies, the ESG_VC framework provides 48 ESG measurements for venture capital firms to report at different stages, from seed to growth.

VentureESG: Developed with over 450 venture capital funds and 110 limited partners, VentureESG provides tailored resources and tools including an ESG framework, Code of Conduct templates, term sheets and policies.

ESG Data Convergence Initiative (EDCI): Founded by CalPERS and Carlyle, over 450 private capital firms and investors participate in the Initiative which has sought to streamline reporting metrics from across the private capital industry focused on a set of core ESG metrics from existing frameworks.

ImpactVC: Originally formed at Better Society Capital, ImpactVC is community of VCs who provide resources to help accelerate impact within the venture industry primarily through the establishment of a community of leaders and the development of open-source tools and products

Impact Frontiers – Reporting Norms: Focused on innovation, collaboration and community, Impact Frontiers facilitates engagement to develop practical tools that can support investors manage and integrate impact, covering financial data, analysis and processes, with a specific focus on areas where neither guidance nor standards currently exist.

The investment case: supporting long-term sustainability objectives

Examples of the strong sustainability impact of venture capital and growth equity investment

The BVCA Responsible Investment Toolkit provides practical advice for investors and the managing partners of a fund with an ESG strategy. The Toolkit signposts guides for best practice and case studies which demonstrate the strong sustainability venture capital and growth equity investment can have.

ALTRUISTIQ®

London

Molten Ventures (venture capital)

Altruistiq, is an early-stage technology company providing a Sustainability Data Management Platform. Altruistiq is on a mission to help companies build, buy, and deliver products that are better for the planet. By working with companies with complex operations and large global supply chains, Altruistiq is confident in its ability to rapidly grow its 'carbon emissions under management' which are the total Green House Gas emissions of its customers.

By working with companies with complex operations and large global supply chains, Altruistiq is confident in its ability to rapidly grow its 'carbon emissions under management' which are the total Green House Gas emissions of its customers. Altruistiq is also pursuing an internal carbon-neutral strategy through decarbonisation and offsetting. This has included moving to a sustainable office provider and migrating all its cloud usage to a data centre which uses 100% renewable energy. Altruistiq's travel, professional services, office space and purchases are offset with a blended bundle of nature-based carbon removal sustainable forestry credits and UK-based peatland projects.

TANGLE TEEZER®

London

Mayfair Equity Partners (growth equity)

Tangle Teezer is a hugely successful hairbrush brand, having sold over 100 million brushes worldwide. Partnering with Mayfair Equity the company has made a number of interventions to make the brand even more sustainable.

Tangle Teezer has been introducing cardboard packaging over the last 9 months to replace its single-use plastic packaging which should enable them to eliminate plastic from their packaging completely. The brand also offers consumers the ability to recycle any plastic hairbrush online, and in early 2023 they launched the Plant Brush, made from innovative, plant-based materials. And as a fast-growing Global business, Tangle Teezer have taken the decision to expand their supplier base to reduce their overall carbon footprint.

BRAMBLE ENERGY

Crawley

BGF (venture capital)

Investing in new low carbon energy solutions to make them work, Bramble Energy looks to solve these problems by constructing hydrogen fuel cells using materials and manufacturing techniques with already well-established supply chains.

This makes the whole process more scalable, flexible and more in-line with the typical costs associated with incumbent electricity generating technologies. It was Bramble Energy's world-first in the production of hydrogen fuel cells that piqued the interest of BGF, who led a £5 million investment round into Bramble in 2020, alongside existing investors including IP Group, Parkwalk Advisors, and UCL Technology Fund.

BGF, as a leading investor in the field of clean growth, saw great potential in Bramble to transform a global and growing market. And with BGF's support and long-term partnership, Bramble Energy is now one of the only fuel cell companies in the world with the manufacturing capacity to supply gigawatts of fuel cell hardware.
To put that into perspective, one gigawatt is roughly the size of two coal-fired power plants and is enough energy to power 750,000 homes.

Focus on savers' returns: the Value for Money framework

Moving the focus away from short-term costs to long-term value is a priority that everyone can agree on. Work is already well underway on the development of a new mandatory framework. It is important that industry, Government and regulators co-operate to ensure it is successful in improving risk-adjusted net returns.

The importance of value for money

The issue of value for money in DC pensions has been particularly topical, and the Expert Panel strongly supports the idea of shifting long-term focus away from cost, and towards long terms returns for pension savers. It's clear that this process has begun, with the Productive Finance Working Group recommending a shift in the focus towards long term value for DC scheme members in its 2021 roadmap. Since that work was completed there have been important changes made to the DC charge cap, and increasing recognition of the long-term inadequacy of the average DC savings pot for funding individuals' retirements.

However, there remains strong consensus across the pensions, private capital, professional services industries, and stakeholders that DC savers would benefit from a more pronounced stepchange in how costs are assessed in the process of choosing a pension provider. The existing focus on costs and charges – particularly by employers in meeting their auto-enrolment obligations - may have the effect of suppressing the potential returns for savers. Though clearly most providers are concerned about the long-term adequacy of pension pots, the wider commercial and regulatory ecosystem is, despite the best intentions, not necessarily supportive of providers taking a long-term view.
In 2023, the FCA and DWP consulted on a Value for Money disclosure framework

In 2023, the FCA and DWP consulted on a Value for Money disclosure framework, which sought to shift the focus away from cost, and provide information to trustees, providers and Independent Governance Committees to inform and challenge whether their investment strategies are working in the best interest of savers. The joint FCA, DWP and TPR response has stated that the focus of the framework will be to "support and accelerate the consolidation of underperforming and poorly run schemes...so no saver is left languishing in an underperforming scheme". In 2024, the new Labour Government confirmed it intended to continue with plans to introduce the framework, with a further consultation published by the FCA in August 2024, and the announcement of accompanying legislation as part of the Kings Speech in 2024.

Recommendation

The Expert Panel recommends 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.

The panel noted the following elements as being of particular importance in the development of the framework:

- That the framework is designed to ensure that schemes are not penalised for short term performance dips that may occur because of the 'J-curve' investment cycle of some assets.
- That steps are taken to ensure that the framework informs the advice given by Employee Benefit Consultants to employers, and that given by investment consultants to schemes, to ensure this alters the way costs and returns are considered in decision making.
- That FCA continues to monitor the landscape to ensure that the framework does not encourage 'herding', whereby schemes become more risk adverse out of fear as being classified as an 'outlier' relative to the relevant benchmark.
- That metrics are consistent with other disclosure requirements, particularly in relation to costs and charges. Where different rules and methodologies are identified across regulations, then steps should be taken to streamline the rules, and ensure all mandated reporting metrics avoid an undue focus on cost.

Focus on savers' returns: the value for Money framework

Moving the focus away from short-term costs to long-term value is a priority that everyone can agree on. Work is already well underway on the development of a new mandatory framework. It is important that industry, Government and regulators co-operate to ensure it is successful in changing attitudes.

- That the private capital industry fully engages in the development of the framework to ensure that the metrics are compatible with private capital reporting.
- The Expert Panel also encouraged industry to ensure that all templates designed to support pension scheme disclosure requirements are updated to reflect the framework, to ensure that the data and metrics needed to meet these obligations are easily obtainable throughout the investment chain.

Next steps

In August 2024, the FCA published a further consultation on the detail of a Value for Money framework. The BVCA will be submitting a response on behalf of private capital funds and many of the bodies involved in this project will also be engaging. The Expert Panel will discuss whether it should make a submission highlighting its key findings.

Australia 's Regulatory Benchmarking Approach

Australian 'superannuation' schemes are subject to a regulatory benchmarking approach to assess VFM and to hold funds accountable for poor performance.

Schemes are subject to a two-part performance test, which assesses their 5-year investment performance relative to a benchmark portfolio using the product's strategic asset allocation, as well as an assessment of administrative fees relative to median fee level for that category of product.

If a product underperforms the test by more than 0.5%, it is deemed to have failed the assessment. Those identified as being poor performers have to inform their own members and, where failure occurs over two consecutive years, are prevented from accepting new members.

The Australian Tax Office (ATO) also offers a 'YourSuper' comparison tool, to enable members to compare the performance of their product with others in the market. Those contacted by a 'failing scheme' are directed towards this tool.

Though the approach is relatively new, it has been influential in the UK thinking. Critics note that there is some evidence of investment herding, and the system is based on individual savers acting, rather than schemes. Both these have been acknowledged by the FCA as considerations in the development of a new system. However, there is also a great deal of support for the UK DC landscape adopting a more competitive environment when it comes to pension performance.

The investment case and transparency

Private capital explained

Private capital explained: an overview of the industry

The value proposition of private capital firms is generally based on successfully identifying promising unlisted companies, acquiring either minority or controlling stakes, spending several years increasing their value, and then selling them at a profit for investors. Within this broad approach, there are different investment strategies aimed at different stages of companies' growth, with different considerations for investors.

Private capital asset classes and considerations for investors

Private capital, in this report, is the collective term for the venture capital, growth equity and global buyout industry which provides investment for businesses at different stages of their development – ranging from early-stage to mature companies – dependent on the investment strategy of the fund. The focus of this report is on venture capital and growth equity whose funding is part of the growth journey for thousands of small and medium sized companies in the UK. The definitions of each of these asset classes are set out in Appendix 1.

Private capital funds pool investment from institutional investors from the UK and around the world, including from pension funds, sovereign wealth funds, insurance companies, family offices or university endowments.

The investment strategy adopted by a private capital fund relates to the asset classes noted above. There are several key differences that investors will need to consider in relation to each asset class, including the hold period and fund size. Venture capital firms back early-stage companies and as additional capital is required to enable companies to develop and increase scale, growth equity firms provide this critical source of capital to enable a company to continue to innovate and create jobs. Growth equity firms also offer a different skill set to help manage companies, including expertise on how to grow a successful company, alongside managing risk.

Venture capital and growth equity funding allows a company to expand its reach, take risks, scale, and provide expertise to help navigate the journey to becoming a mature, larger business. An outline of the key considerations for investors is set out on the following page.

Performance metrics – IRR is just one of a number of measures

The private capital industry has several metrics that measure the returns that are generated through investment in private capital funds, including but not limited to the often-cited Internal Rate of Return (IRR). Facilitating greater understanding of the metrics used within the private capital industry to measure performance is essential to establishing how investors could improve risk-adjusted net returns as part of a diversified investment portfolio.

The evolution of the performance of a fund throughout its life and the range of metrics that are used to provide investors with a full picture of this development. Further detail on performance metrics are set out in Appendix 1.

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Examples of resources for building mutual understanding

There are several industry-led resources that can help aim to increase mutual understanding of how the private capital industry works. These resources include guides, reports and training modules to help increase understanding of the private capital industry. This includes:

PwC's Report to the Expert Panel – produced to provide an overview of the key issues and challenges that currently limit pension fund investment into private capital, this report sets out the existing and emerging structures in the private capital industry and key considerations for DC scheme investment.

Productive Finance Working Group (PFWG) Investing in Less Liquid Assets: Key Considerations - produced by the industry-led PFWG which sought to develop practical solutions to the barriers that prevent investment into long-term, less liquid assets.

The Pensions Regulator (TPR) Private markets investment guidance – designed for trustees of occupational pensions schemes considering an investment into private markets. This guidance provides an overview of what private market assets are and the key matters and considerations for DC schemes.

British Private Equity and Venture Capital Association (BVCA) Introduction to Private Equity and Venture Capital Training – designed to help improve understanding of the private capital industry, the roles of all of the players and how their work contributes to the success of the business. It will help clarify terminology and includes reviews of the structure of funds, the investment process, how returns are generated, financing structure, fund reporting and administration.

Pensions and Lifetime Savings Association (PLSA) Long Term Asset Funds (LTAF) Made Simple – produced in partnership with Partners Group, this guide explores the structure of the LTAF and aims to demystify private markets.

Next steps

The BVCA and TEG will work with TPR to develop a specialised training module to increase pension industry understanding of the private capital industry

Considerations for investors

Private capital investments are long-term investments that should fit well with pensions investors' timeframes. There are important differences between venture capital and growth equity funds that investors should consider:

Strategy	Venture Capital			Growth Equity
Typical hold period	Seed Varies – 6-8 years but can be 10 or more years for high performing assets	Series A 5-7 years - can be 10 or more years for high performing assets	Late-stage venture 5-7 years	6 years
Typical fund size	Seed £20m-£100m	Series A £100-£300m	Late-Stage Venture £300-£800m	£200m-£5bn
	Multi strategy VCs can raise £1bn+ funds			
Typical number of investments per fund	Seed 20+	Series A 10-30	Late-stage venture 8-20	10-20
Typical fund life	10+ years			10 years
Typical exits	Trade sale/strategic acquisition, IPO, sale to private equity*			Trade sale, sale to another private equity firm, IPO*
Secondary market	Exists but small			Developing
Key return drivers	Rapid growth in small number of scalable companies (power law)			Consistent growth across portfolio; some leverage
Risk considerations	Higher failure rate in portfolio, wider returns dispersion, less liquidity due to smaller secondary market			Lower failure rate, narrower returns distribution, larger secondary market
Returns	11%* (10-year horizon IRR - 2023)			10.7%* (10-year horizon IRR - 2023)

Private capital explained: risk considerations

The specific characteristics of private capital investments mean that the standard risk management tools that are used in other asset classes are unlikely to be applicable. Instead, there are specific risks in private capital that DC schemes should be aware of and seek to mitigate. There are various tools for doing that, but diversification across assets and funds is key.

Private capital risk factors are not the same as those used for public markets

Risk management in private capital requires firms to consider risk differently to how they approach it in public markets because of fundamental differences in the asset class. These include (i) the absence of daily pricing (which reduces the usefulness of risk measures of public markets, such as volatility, value-at-risk or shortfall-risk and makes it difficult to measure market risk and (ii) the illiquidity of closed-ended funds which means liquidity risk is more prominent.

As a result of these and other features, the listed approach to market risk, credit risk, liquidity risk and funding risk need to be adapted in a private capital context. While the use of the same risk factors for both private capital and the public markets is difficult, it is still possible to measure and calculate similar risk measures. One way of considering this is set out here:

	Public markets	Private markets	
Market risk	Change in value/price	Difficult as no market prices exist. The closest estimation might be "Interim NAV volatility"	Market/NAV Volatility risk (short & mid-term) Capital risk (mis- & long term)
Credit risk	Loss of assets due to issuer's credit events	Credit risk is only part of a risk in private equity and is more akin to any risks associated with the GP's abilities and the various "external" factors which can impact a PE investment. Credit risk models overestimate risks as they only reflect downside and not the large potential upside in private equity	
Liquidity risk	Redemption possibility; liquidity when selling assets	No redemption possibility, but still relatively small and inefficiant secondary market exists	Liquidity risk
Funding risk	Investors not able to finance furture liabilities	Risk that the legal obligation to pay for commitments cannot be funded by the investor	Funding risk

Funding risk (or default risk) – managing cashflows

This is the risk that an investor such as a DC scheme is not able to provide its capital commitments when called to do so by the private capital firm. Default can lead to an investor losing its full investment including all paid-in capital. This means it is critically important for investors that they manage their cash flows to meet their funding obligations effectively. This is seen as a last resort measure, which is preceded by "cure" provisions and almost never occurs in practice,

Funding risk can be measured through a "funding test" or through cash flow models which take extreme cases into account. The funding test places the undrawn commitments in relation to the resources available for commitments. A cash flow model provides the investor with a simulation of the expected capital calls and distributions in the future. It is very important that extreme scenarios are also considered in which capital calls are much higher than distributions and, hence, large amounts of outside capital are necessary.

Investors can reduce funding risk by assessing their future commitment plan with cash flow simulations and cautious planning. Investors with limited external capital available or large allocations to illiquid assets should be more cautious on the over-commitment and self-funding strategy. However, when deciding on such a strategy, investors should be aware of possible extreme scenarios and how much cash would be necessary and how this could be obtained from other sources. A strategic plan for these extreme cases as well as the portfolio construction plan is the key element.

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Liquidity risk – secondary markets and diversification

This is firstly the risk that an investor is unable to redeem their investment at the time of their choosing. Private capital funds typically do not permit redemptions (which is essential for long-term growth of companies and required by other investors). However, there are now established private capital secondary markets and so liquidity risk can also be regarded as the risk that an investor wants to sell its fund interest on the secondary market, but fails to secure acceptable terms. It is important to note that the secondary market for interest in private capital buyout funds is deeper and better established than for venture capital funds.

Liquidity risk in private capital is difficult to reduce, although it is simpler to handle for investors in an overall asset allocation model. If private capital is only a small part of a well-diversified asset allocation, many other assets are more liquid and can be traded. Since most investors have other assets which are easier to liquidate in times of financial instability than private capital, DC schemes should consider running a funding test and selling other assets before selling private capital fund interests.

Market risk – using NAV as a substitute

Market risk is the risk of holding an asset which can be traded on a (secondary) market and whose value changes over time. This risk often refers to equity in listed companies through the purchase of stocks. Due to the lack of real continuous market prices for private capital, quarterly net asset values are often used as substitutes for market prices. With NAVs as substitutes, it is possible to calculate typical public market measures such as periodic returns, their volatilities and correlations with returns from other asset classes.

Capital risk – diversification reduces risk substantially

Capital risk for the investor is defined as the probability of losing capital with a private capital portfolio over its entire lifetime (it is worth noting capital at risk is limited to an investor's commitment i.e. no recourse to an investor's wider portfolio). Studies have shown that, over the long-term, internal factors are critical when building a successful private capital portfolio. Investors are able to minimise their capital risk significantly when diversifying over a large number of funds in many geographies, industries, and over many years and with different fund managers. In general, the best results have been achieved when funds have equal weighting with the same investment strategy. Apart from investing in direct funds, doing so in funds of funds, co-investments and secondary funds can greatly increase diversification.

A study commissioned by the BVCA suggested that an investor randomly selecting one fund has a risk of losing some capital in 28% of cases. A randomly selected portfolio of five funds results in a reduced risk of 10%. In the case of a randomly selected portfolio with 20 funds, the risk for an investor is substantially reduced to 1.4%. This means the risk of losing any capital for investors who hold a portfolio over the entire lifetime (or at least 10 years) is very low (and can be reduced further by adding more funds).

More detail on practical methods of evaluating private capital risk

Further detail around the above as well as the evidence base for how far capital risk can be reduce through diversification (and other topics) is available on the BVCA website in a study conducted by Montana Partners, using a variety of datasets.

Private capital explained: valuation of portfolio companies

For private capital portfolio company valuations to be used with confidence as an input for determining scheme unit prices, it is important for DC schemes to understand how valuations are derived, as well as the considerations around their less-than-daily frequency.

Private capital valuations compared to public market pricing

Private capital is an equity investment into unlisted companies. These are not traded on a secondary exchange like the shares of publicly listed companies, so there is no regular market price available. Only when the company goes through a new investment round in a venture capital context (e.g. series B, series C etc.) or is sold to an(other) investor(s) (including via IPO) can market value/price be observed (typically after several years holding). Private capital firms still derive a value for each company, but these net asset values (NAVs) are not market prices based on actual transactions. They are similar to accounting values and reported to investors quarterly to provide an indicative 'price' that portfolio companies might fetch if sold, based on their unrealised valuations.

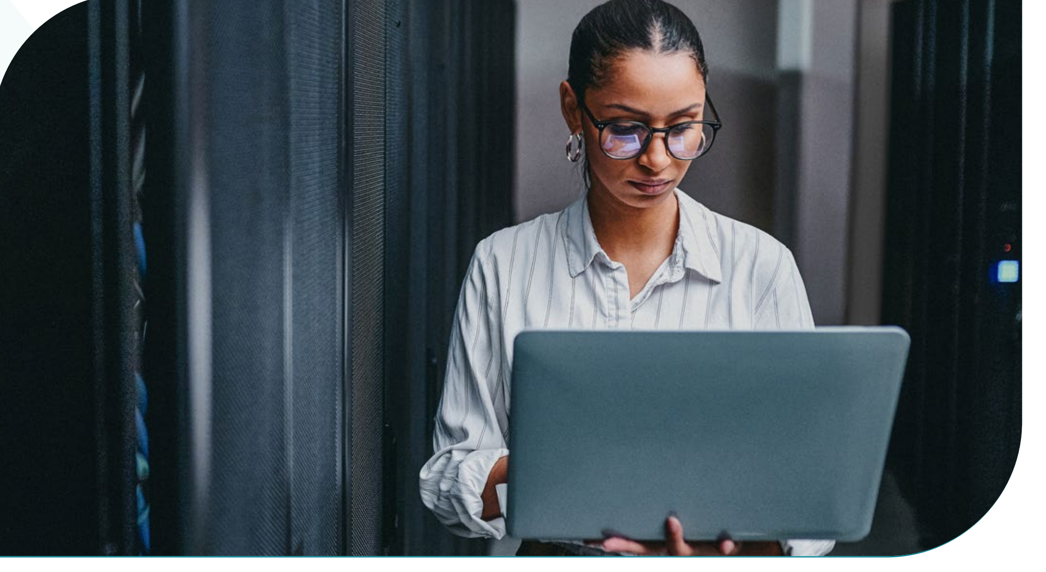
Governance, process and methodology (including audit)

Private capital firms need to provide robust valuations to maintain investor relations, inform decision-making for portfolio management, allow investors to make strategic asset allocation decisions and monitor exposure limits, and to support an effective secondary market. Governance, processes and methodology across the private capital industry is relatively standardised and underpinned by:

1. Regulation covering governance: The FCA's rules derived from the UK/EU Alternative Investment Fund Managers Directive (AIFMD) provides protection to professional investors on areas such as conflicts of interests and independent asset valuation.

2. Standard methodology based on global accounting standards: The International Private Equity Valuation (IPEV) Guidelines provide a widely-adopted and regularly, independently reviewed methodology for private capital valuations (across venture, growth and buyout). This overlays global accounting standards (such as IFRS and UK/US GAAP) with an interpretive framework that is typically insisted upon by global investors.

3. Audit and close third-party scrutiny: Valuation reporting involves multiple steps ensuring scrutiny and challenge, with internal valuation and risk committees, third-party review, investor oversight through limited partner advisory committees, and submission to fund auditors.



Private capital explained: valuation of portfolio companies

DC-specific considerations

The Expert Panel and TEG felt that the most commonly perceived challenges for DC with private capital valuations relate to: (i) their lower frequency (quarterly or less) relative to the daily observable price of listed securities; and (ii) the degree of confidence amongst DC that the methodology for ongoing valuations will produce a figure that correlates with the price ultimately achieved when the company is sold, and will not need to be adjusted retrospectively (especially if the need for adjustments only comes to light after DC scheme-level transfers using the original valuation data have already happened, as retrospective fixes in this scenario would be extremely difficult):

1. Frequency: Private capital valuations are typically carried out quarterly because: (i) the absence of daily trading or redemption rights in closed-ended funds usually means there is limited demand for firms to report values on a daily basis; and (ii) valuations are unlikely to vary significantly between quarters given the extent to which they emphasise business fundamentals, which are usually less volatile than public market sentiment. DC schemes still need to provide a daily unit price for members' portfolios. This means that, for any private capital allocations within their portfolios, they must either use the latest available valuation or develop a model for making more regular adjustments to quarterly valuations. This is considered further in "Market innovations: private capital unit pricing", below.

2. Confidence in correlation with actual sale proceeds: There is little evidence of the sale of private capital portfolio companies delivering lower returns than those suggested by the latest carrying valuations. If anything, there seems typically to be a modest uplift in exit price above what might have been expected from the prior quarter's valuation report, at least for buyout funds (see Bain Global Private Equity Report 2023). It was also noted that there is a reliance on valuation figures might be hindered by perceptions of the variation between listed equity pricing (significant discounts to NAV), private capital secondary market pricing (which shifts with the economic backdrop), and average portfolio company exit prices (which tend towards a premium on the most recent valuation).

Private capital explained: fees, expenses and carried interest

The costs and charges provisions of a typical closed-ended private capital fund share some similarities with how asset managers are remunerated for managing portfolios of liquid assets but differ significantly in their mechanics. These key differences need to be considered in the context of the DC charge cap and more broadly in the design of DC products seeking to access the private capital fund market.

Why private capital investment strategies cost more to execute

The level of hands-on ongoing activity required in venture capital and growth equity is significantly greater than that required in many other types of investment. Identifying and executing investment decisions often takes months, involving specialist research; extensive due diligence and negotiations using external advisers. Once invested, the active ownership and value creation phase then involves a range of specialised business growth expertise in operations; governance; strategy; multi-year business plans; capital investment; ESG expertise and more. This is significantly more involved and sustained, and therefore more cost intensive, than for example researching, ordering and monitoring public trades. This model of investment value creation requires significant up-front expenditure by private capital firms, and sustained effort over multiple years before achieving returns. These features underpin the model of relatively higher management fees (representing effort and cost required to execute the strategy) and carried interest (representing the need to sustain that effort over many years, enabling out-sized net performance versus public markets) that is used for private capital investing globally.

How and when profits are distributed (the "waterfall")

Investing in a private capital fund does not mean providing capital on day one, rather making a contractual commitment to provide capital on 10 days' notice (typically quarterly), most of which is usually provided during a (typically) five-year "investment period", up to an agreed maximum amount, as and when required to by the fund manager for the purposes of investing in companies, paying fees, and covering expenses.

The fund strategy is to sell its stakes in investee companies, typically after a three-to-seven year holding period, at a profit. The order in which the fund's proceeds from the sale of portfolio companies are distributed when realised is typically as follows (this is a simplified version of a typical European "waterfall" and there are variations in the market between funds, fund types and jurisdictions):

1. 100% to investors (capital repaid): until the money drawn down from investors is repaid, including that drawn to pay fees and expenses.
2. 100% to investors (preferred return on capital contributed to the fund): until investors have received a (typically) 6-8% "preferred return" (more common in growth equity than venture).
3. 100% to the manager (catch-up): until the private capital firm has received 20% of returns distributions (i.e. an amount equal to the preferred return already received by investors). (more common in growth equity than venture).
4. 80% to investors, 20% to the manager (return share): as the typical return share ratio. The 20% return share (including any catch up) is known as "carried interest" - the manager's right to any returns is carried over until the fund as a whole is profitable from exits.

Private capital explained: fees, expenses and carried interest

Fixed fees are charged on committed capital, not NAV, and reduce over time

Unlike many liquid investment products which charge a fixed amount of the value of a fund's assets, fixed fees in private capital funds are charged, typically between 1.5% and 2.5% annually, on the amount an investor has committed to the fund. Private capital management fees are therefore a predictable, fixed amount of money each year during the first five years when the fund is investing (the "investment period"), regardless of ongoing valuations/NAV.

After the investment period, the basis of the fixed fee calculation for buyout and growth equity funds typically changes to the acquisition cost of as-yet unsold portfolio companies (or similar). This is a lower amount than the total committed capital, so produces a lower fee which reduces ultimately to zero during the second half of the fund's life, as the fund's portfolio companies are gradually sold. Venture management fees often operate slightly differently, usually paying fees based on commitments throughout the fund's life (but with reduced percentages in the later years) because of the numerous subsequent funding rounds of portfolio companies and activity required towards exit.

Fund expenses and portfolio fees

Fund expenses: Each fund agreement is negotiated between investors and the private capital firm and will come to different arrangements in relation to which expenses of the fund (establishment costs, legal fees etc.) are borne by investors (including the private capital firm in respect of its own commitment to the fund as an investor, see below). This is an area where investors seek disclosure and negotiate with the fund manager.

Portfolio fee offsets: Certain other fees may be paid, more commonly in buyout funds, by portfolio companies to the private capital firm (e.g. external advisory fees, monitoring fees, board fees etc.). Whether these are offset against and reduce the management fee is a matter for negotiation, but a 100% offset is common.

GP commitment ("skin in the game")

Investors often require private capital firms to invest in their own funds ("co-invest") to further the alignment of interests, in particular as regards downside risk. The level of commitment required varies, from 0.5% or less to over 2% of the fund size. By having "skin in the game", managers share significant investment risk, which helps to build trust with investors by signalling the managers' confidence in the fund's strategy and success.

Private capital explained: fees, expenses and carried interest

Focus on carried interest

Carried interest, or “carry”, is considered to be an important mechanism for binding together the success of private capital firms with that of the external investors who entrust them with their capital. This is a “shared equity” model under which the investment professionals only receive their share (the carried interest) if the fund’s investments deliver outstanding performance beyond a preferred return, typically around 8%.

This involves long timeframes, with everyone locked together and committed for many years. It also involves entrepreneurial risk-taking, with no guarantee of success, and carry participants only receiving payments if and when the fund delivers strong returns to investors. Private capital managers act as active owners who shape portfolio company management teams, implement new strategies, bring in external expertise to make businesses more competitive, and are focused on value creation in the businesses throughout their stewardship. Managers receive nothing by way of carried interest unless the capital value of the investments and the returns from the funds hit the high thresholds agreed at the outset and demanded by investors.

This model aims to align the interests of private capital managers with the interests of investors: both are highly motivated to ensure that the fund’s investments are successful. Indeed, institutional investors from around the world often demand that this alignment exists from day one and throughout the life of the fund and will only invest if they are satisfied that managers are sufficiently incentivised.

Carried interest therefore binds private capital managers’ fate inextricably, and deliberately, with outstanding performance in the investments they make. Meanwhile, for the wider economy, we have businesses that are more productive, more internationally competitive and that power growth across the country.

Carried interest versus performance fees

The (typically) 20% share of a fund’s profits that are paid to the manager as carried interest is only received if and when a fund has returned investors’ capital plus the preferred return (typically 6-8% annually). Typically, private capital firms will only start to receive carried interest as a capital gain once investors are enjoying healthy returns from profitable exits (towards the end of the life of a successful fund e.g. from around year 8). This model creates long-term alignment of the firm’s interests with those of its investors and is used across the private capital industry globally.

Open-ended funds (uncommon across private capital) with performance fees pay these on both realised and unrealised gains using increases in NAV (exchange price where available or ongoing valuations) rather than realised returns. This can be used as the basis for an annual performance fee as a more regular fee income stream that does not depend on successful exits. The challenge for alignment is that strong performance on paper, which can fluctuate from year to year, may not ultimately be backed up by successful exits. There is a higher risk of overpayment in open-ended funds because performance fees are not reliant on investors receiving their capital back prior to fees being paid. The rational is that investors could have chosen to redeem at the same point as the fees are crystallised. As a result, performance fees can be paid in a strong year and, if the fund subsequently declines in value, investors who have borne these fees may on exit subsequently not receive a return that necessarily reflects this. This is widely known and accepted feature of open-ended funds with performance fees, that is not present in the cash-on-cash alignment / fee model typically seen in private capital funds. Firms may want to consider “high water marks” and other open-ended fund technology to translate the inherent long-term alignment in the carried interest model into an open-ended context.

Facilitating clarity on costs

DC pensions need to have confidence that they have full oversight of costs. Private capital firms have also explained that they want clarity on what DC investors require. There are a number of existing cost disclosure requirements and frameworks – more work needs to be undertaken to ensure they are consistent and decision-useful.

The importance to DC investors of clarity around costs

For DC pension schemes, clarity on fees and costs is essential in providing the confidence to invest in private capital. The need for consistent and transparent reporting throughout the investment chain is an area of strong consensus across the pension, private capital and advisor communities.

However, the Expert Panel also identified various friction points in the process which, in turn, risks private capital firms not having a clear understanding of the reporting needs of pension scheme investors, and pension schemes not feeling confident they are correctly reporting the costs associated with their investments.

A range of existing frameworks

DC schemes are subject to a number of rules on the reporting of investments costs. The relevant frameworks include:

- The Occupational Pension Schemes (Charges and Governance) Regulations 2015
- Pensions Act 2014
- The DWP's charge cap guidance from (2022 version)
- The DWP's 2023 Statutory Guidance on Disclose and Explain (on asset allocation and performance based fees).

This effectively results in schemes needing to disclose fees both in the Chair's Statement, and as part of their DC default charge cap disclosure, and to take account of regulations, statutory guidance and non-statutory guidance. The Expert Panel noted that cost disclosures have, historically, been a significant determining factor for employers selecting an appropriate scheme to meet their auto-enrollment responsibilities. The Value for Money framework will also require pension schemes to disclose costs, based on standardised metrics.

Industry has already established voluntary frameworks to assist the flow of information flow through the investment chain, including the Cost Transparency Initiative Private Markets Sub-Template, Invest Europe's reporting guidelines, and the Institutional Limited Partners Association's reporting template.

However, with the exception of the Cost Transparency Initiative, reporting on costs by fund managers is not necessarily designed specifically to meet the needs of UK pension investors. Indeed, the Expert Panel heard that some disclosure regulations, for example, the packaged retail investment products (PRIIPS) Key Information Document rules, differ substantially from the cost disclosure needs of DC pension schemes. It is worth noting that PRIIPs rules are likely to be replaced in the UK in 2025, and engagement of the private capital and pensions industries in this process will be important (notwithstanding that PRIIPs KIDs are not typically required for private capital funds due to the usual absence of retail investors).

The Expert Panel also found that the lack of consistency and guidance in the 'Request for Proposal' process resulted in fund managers not responding in a consistent manner, and pension schemes therefore not making like-for-like comparisons when assessing costs of different investment options. In particular, pension funds noted that they are not necessarily familiar with the different types of costs association with private capital, and the uncertainty could be problematic.

The Expert Panel found that the lack of clarity on 'look-through' - the process of calculating the underlying charges in fund-of-funds structures - added a further layer of uncertainty, with no detailed guidance on the expectations for DC schemes, and a general consensus that proportionality was desirable in the reporting of costs associated with these type of

Facilitating clarity on costs

investments.

Overall, the Expert Panel recognised that, despite the multitude of disclosure requirements and frameworks, a lack of consistency left pension schemes not feeling confident that they would have access to information needed to meet their own reporting obligations, and private capital firms did not feel they have a clear understanding of what they needed to provide. Often, it felt like the different parties were 'not speaking the same language on costs'.

The Expert Panel recognised that perceptions of challenges around cost transparency in private capital, driven by the lack of consistency, could fuel a loss of DC confidence in the relationship. Some further activity to align reporting and sight of costs could have a real impact on how confident DC sectors feel about private capital investments.

Next steps

In the second phase of this work, the Expert Panel plans to put together a working group to explore the possibility of a Model RFP. This will seek to foster more effective communication and ensure that DC investors and private capital 'speak the same language' on cost and returns metrics.

Recommendation

The Expert Panel recommends that:

Consistent cost disclosure requirements should be applied across the investment ecosystem.

The private capital and pensions industries should work together to develop a model Request for Proposal.

The investment case and transparency

Industry innovations

Industry innovations: private capital unit pricing

The lack of daily valuations for private capital investments has often been cited as a barrier for daily priced DC pensions. However, there are solutions and the Expert Panel believes this should not represent a barrier to investment.

Considerations for building fair DC pricing models for private capital

DC schemes need to calculate a fair daily price for the pots held by individual pension savers. Where a pot includes private capital investments, this can be challenging, for a number of reasons mainly related to the timing of costs and returns:

- **Frequency of valuations:** Unlike in public markets, private capital assets are not priced daily – funds are typically valued quarterly. Feedback collected by the Expert Panel suggested commissioning more frequent valuations would usually be prohibitively costly, and not necessarily worthwhile (although it is possible for service providers to deliver daily estimates, at a cost, as is sometimes done in the US market).

- **'J-curve' returns profile:**Private capital returns therefore often follow a 'J-curve' profile – an often multi-year phase of negative returns as capital is invested to acquire companies and pay fees during the first half of a fund's life, followed by a period of positive returns as sales of portfolio companies allow capital to be returned and fees to be repaid. For DC, this can result in investments registering a short-term loss on paper.

- **Carried interest:** Carried interest is received by private capital firms only when portfolio companies are sold at a significant profit, and reflects a share of the return made on the underlying investment. It generally arises during the second half of the fund's life. Again, this poses a challenge for DC schemes when seeking to ensure fairness between scheme member pots.

- **Management fees:** Private capital fund management fees are typically a fixed amount (a percentage of investor's capital commitments, draw down or otherwise) during the first five or so years of a fund's life, but then reduce gradually during the remainer of the term, as portfolio companies are sold.

These features mean that ongoing performance measures are less effective indicators of the true or ultimate value of private capital fund interests early in a fund's life than they are towards its end.

Providing a daily price for less frequently valued assets

Calculating a daily price for unlisted assets like private capital investments requires thought and a degree of judgement. Nonetheless firms can and do already provide daily prices for illiquids in various contexts. Relevant learnings from that experience which may be useful for DC providers more widely include

- Using the latest available valuation – i.e. holding private capital assets at their value as reported at the date of the last available valuation. The frequency of the formal valuation of private capital fund assets varies, quarterly being relatively standard (although LTAFs are required to value their assets monthly and an investor can request an estimate at any time). With the appropriate governance in place, schemes could choose to override that when necessary to ensure fairness and set their own price (probably most applicable where there have been sudden market movements).

- Acknowledgement that daily pricing is not necessary or achievable at a reasonable cost for a long-term investment, such as a DC pension pot. Though there is no desire to reduce the ability of individual scheme members to move their pots with no notice, it is increasingly acknowledged that it is not always in the interests of the majority of scheme members to retain completely liquid investments to accommodate larger scheme movements, or to ensure that a valuation has been performed within a short period prior to a transaction occurring. Schemes may wish to consider how this informs their policies and communications to members on valuations.

Recommendation

The Expert Panel recommends that:

DC schemes, platforms and advisers should use quarterly private capital valuations, alongside appropriate governance for unusual liquidity events, to ensure fairness between members in unit pricing.

Industry innovations: fee structures

Regulatory changes mean that DC schemes can now accommodate carried interest. However, commercial and operational issues remain discussion points in relation to DC investment in private capital funds with typical global fee structures. A focus on the interests of savers in generating the highest possible net risk-adjusted returns should remain at the forefront of discussions around fees.

Private capital fee structures pose certain challenges for DC

Until recently, the fee and return share structures typically applied in private capital (fixed management fee of 1-2.5% and carried interest applicable usually after a preferred return) was incompatible with DC because the DWP charge cap rules effectively excluded carried interest (and performance fees).

Changes made to the charge cap rules in 2023 now enable DC schemes to invest in products featuring carried interest or performance fees, thereby expanding the options for DC savers. However, it is clear from the feedback obtained by the Expert Panel that some DC schemes continue to have questions about how to integrate carried interest or performance fees operationally, and to an extent commercially. Examples of areas of ongoing discussion include:

- The challenge of applying both carried interest and the associated returns across a scheme's membership, taking into account both the 'j-curve' cycle typically seen in private market investments – where fund interests decline in the early stages before value is generated - and the different investment horizons of different members of a scheme.
- The wider pensions market, where it is clear that, despite efforts to move away from this, commercial Master Trusts face significant competitive pressure to focus on minimising costs, which makes it challenging to prioritise long term returns net of fees in a way that accommodates private capital investment costs.
- Certain concerns about the transparency of fees generally, noted by both pensions industry members and private capital firms. Pension industry members, highlighted that DC needs to adhere to mandatory cost disclosure requirements, and private capital firms, sometimes felt nervous that some pension schemes often did not have a full understanding of the fee structures associated with private markets, and so could benefit from support on how to manage these discussions.

The Expert Panel looked at examples from elsewhere around the world, where DC systems have more experience in making private capital fund investments and are more comfortable with the operational implications. For example, regulators in Australia have issued guidance on the expectations around how schemes can fairly apply fees across member cohorts. Some DC schemes in Australia noted that they amortised some up front fees to ensure those who benefitted from the investment also contributed to the fee.

The Expert Panel acknowledged that the products offered to individuals need to account for the long-term nature of private capital – savers opting into pension schemes early in their careers should have a reasonable expectation that, to maximise returns, they should consider it a long-term commitment. The Expert Panel also noted that, though competition was welcome, DC schemes should avoid over-prioritising low fees, relative to long-term returns profile and ultimate saver outcomes.

Industry innovations: fee structures

Feedback and recent developments

It was clear from feedback to the Expert Panel and Technical Expert Group that private capital firms and pensions professionals want to ensure that fees are well understood, transparent, and do not create blockers for DC schemes seeking to ensure fairness between scheme members.

DC schemes sometimes felt private capital needed to better articulate why private capital strategies typically come with higher fees than liquid strategies, whilst private capital firms sometimes felt DC needed to understand better the resource and operational intensity of executing private markets strategies that is required to deliver outperformance. These are two sides of the same coin, and some suggestions on this topic are set out elsewhere in this Report (see “Private capital explained: fees, expenses and carried interest”, above).

The Expert Panel also recognised the considerable steps already taken to facilitate DC investment in private capital – particularly the changes to the DC charge cap and the introduction of the LTAF. Many of the recommendations made elsewhere in this Report, and current policy landscape, are rightly focused on triggering a ‘step change’ in terms of how long-term value for savers is approached.

Private capital firms had also noted a clear increase in interest from pension schemes being open to accommodating carried interest and performance fees for the first time over the past year.

Recommendation

The Expert Panel recommends that:

All parties should consider in detail how far new and alternative approaches to fee structures might be made to work in savers’ interests.

Industry innovations: fee structures

The Expert Panel and TEG highlighted a number of headline considerations for policymakers, firms and providers as regards industry discussions around fee arrangements other than the common flat fee plus return share approach ("2 and 20").

Headline considerations for policymakers, firms and providers

The Expert Panel believes that fees remain a discussion point and a number of considerations should be borne in mind when firms and providers are considering how to facilitate more investment activity in this area:

- DC providers should consider developing innovative solutions to the operational challenges different fee structures present. For example, some pension providers note that typical "catch up" provisions (see below) had the potential to unfairly penalise some scheme members and so had hindered private capital investment. In these circumstances, consideration could be given to a slower catch up (e.g. 33% instead of 100% catch up) to mitigate timing issues that complicate the challenges around ensuring fairness between scheme members.

- Policymakers should consider how countries with comparable DC landscapes handle these operational challenges. For example, engagement with Australian Superannuation Schemes suggested that both fees and expected returns are 'smoothed out' over the membership, to reduce the risk of cohorts of members being treated unfairly. This is something the Expert Panel plans to look into further in phase two of the project. However, it would welcome further consideration on how the accounting rules can better accommodate long term investment strategies

- Firms and providers should consider open-ended funds and NAV-based performance fee arrangements for DC products. The carried interest model, a feature of closed-ended funds, aims to ensure alignment by only rewarding private capital firms once the fund has made a profit after repaying investors capital and costs (and typically only after delivering a "preferred return" to investors). This model poses timing challenges (discussed at "Private capital explained", above) for ensuring fairness between scheme members leaving and joining at different times. Open-ended funds with NAV-based performance fees may mitigate some of these considerations (as well as facilitating ongoing deployment of scheme capital). In this context, it is worth noting proliferation of mutual funds investing in private capital in the US.

- Private capital firms seeking to work with DC should consider how to provide more certainty on costs and demonstrate discipline in maintaining the figures set out at the outset. Feedback to the Expert Panel demonstrated that DC schemes need certainty of ongoing costs (separately from any management and performance related fee). For many private capital fund managers this would not typically be something that would be determined at the outset.

- In regard to alignment of interests, DC schemes should ensure consideration is given to ensuring managers have invested their own capital in the fund. This may differ from expectations in public markets, and so DC should be prepared to take a more active position on it when exploring private capital.

- It was noted that, though the "2 and 20" model (with some variation) is well established as the standard approach, there are some examples of other models in use in different private capital contexts, which could serve as the basis for further innovation. These and other ideas are explored further in the following slide.

Next steps

Prior to the publication of the final report, the Expert Panel will further explore examples of fee innovations in the market, both in the UK and abroad. It will also do more to help facilitate appropriate discussions on fees and support market development, and consider whether the current rules give DC schemes enough flexibility in how they assign fees.

Market innovations: fee structures

The Expert Panel and TEG discussed a range of initial ideas for specific innovations in private capital fund economics that could be considered and developed by industry when designing products for DC. These are initial ideas intended for further industry discussion. The final Expert Panel report will explore these further.

Headline considerations for policymakers, firms and providers

Competition law prevents the Expert Panel proposing new fee structures or levels, and fees should be determined independently by a competitive market. Below is a high-level summary of TEG discussion around several ideas for potential arrangements that might differ to the typical "2 and 20" approach to private capital fund economics, and the various considerations in relation to each of these. Some elements of some of these ideas can already be seen in the market but others likely remain untested. Some of them will be more, or less, commercially feasible for private capital firms or investors in different contexts.

There are globally established principles behind the typical approach, and the important role of carried interest, relating to the long-term alignment of interests between investors and private capital firms (see "Private Capital Explained", above). Any substantial deviation from market standards should be very carefully considered to establish whether those principles of alignment can be reflected in any alternative arrangements, as returns may suffer for various reasons if not. Private capital firms are restricted in how far they can agree terms that a UK DC investor may seek if other fund investors do not agree (which is reasonably likely, given how widely the current structures are adopted in the global market). Individual investors typically cannot represent more than a specified amount of a commingled fund's total capital (often 10%, depending on key investors' preferences), which restricts DC schemes' ability to negotiate substantially different terms to those sought by other investors in a fund, absent sufficient scale. It is critical for both firms and providers to focus on the fact that savers' primary interests lie in providers generating the best possible returns from a diversified portfolio. Keeping overall fees as low as possible is an important consideration in achieving this, but only to the extent that lower fees do not also come with lower overall net returns.

Summary of ideas raised in TEG discussions

Various potential options, and combinations of them, can be considered. These include lower management fees, higher carried interest, "super carry" (where the performance element starts relatively lower but increases for exceptional performance i.e. significantly higher than a standard hurdle or preferred return), flat fees, a different basis of calculation of fees (NAV rather than commitments or returns), and greater use of management fee income/bonus to incentivise investment teams. Importantly, this report does not consider nor address any technical considerations around tax, accounting rules, legal issues or regulation. These ideas will be considered further, and further analysis presented in the final Expert Panel Report.

General factors that private capital firms may wish to consider in discussions with DC schemes on fee arrangements

- There are often commercial realities underpinning any DC focus on lower fees, especially for commercial Master Trusts.
- DC schemes need to be able to demonstrate confidently to members that higher charges typically come with higher performance and better retirement outcomes.
- DC schemes are subject to specific requirements related to the charge cap and ongoing charge figures that mean they are likely to place a greater premium on certainty and simplicity around ongoing costs and charges.
- Different types of DC scheme (e.g. small versus large, single employer versus Master Trust, platform versus non-platform) will have different constraints and challenges around fees.
- The unpredictable timing and quantum of carried interest payments presents challenges for DC in ensuring fairness between scheme members leaving and joining at different times.
- Open-ended funds and performance fees (in place of carried interest) should be considered for DC schemes, because NAV-based charges and accrued performance fees may be easier for DC to implement operationally.

Industry innovations: fee structures

General factors that DC schemes may wish to consider in discussion with private capital firms on fee arrangements

- There are legal and commercial challenges in agreeing different arrangements for UK DC relative to global pensions and other investors. Private capital firms are llikely to face resistance from other investors in funds to substantial deviations from market norms (the perspective of the BBB/BPC is also important here for smaller funds).
- UK DC schemes face competition with global investors for access to funds managed by firms with strong track records, which is a consideration for DC schemes seeking the best returns.
- Arrangements with a larger performance element relative to management fees do exist in the market, although they are not typically favoured by global investors.
- Any front-loading of strategy execution costs (due to e.g. lower or NAV-based management fees) is challenging, especially for smaller or newer firms with less resources, as there will be challenges in "keeping the lights on" or attracting and retaining investment teams, especially during ramp up. This may dissuade such firms from offering DC focused products.

How international pension funds and other investors typically reduce overall fee burdens

DC schemes should consider how some international pension funds with successful private capital investment programs have managed to reduce the overall fee burdens of their private capital investment programs. These include relying on large commitment sizes to negotiate reductions in fund management fees, or agreeing alternative overall economics in relation to substantial co-investments or under bilateral 'separate managed account' relationships. It is worth stressing that being able to deploy significant amounts of capital is key here.

The investment case and transparency

Policy innovation

Government initiatives

Various government-led initiatives have been implemented to facilitate investment from pension schemes and other investors into private capital, in the UK and overseas. These offer learnings for a new UK initiative for investment in high growth companies.

The role of Government

The Government has indicated that it sees a role for itself in encouraging more investment into certain areas of the economy. In the days following the General Election, Chancellor Rachel Reeves announced a new National Wealth Fund, 'to unlock investment in new and growing industries'. In an earlier Financial Services plan, the then opposition Labour Party also proposed the launch of a 'UK Tibi Scheme', based on the scheme launched in France.

Government support in facilitating investment in growth through venture capital and growth equity can be highly effective in giving larger institutional investors the confidence to invest. This can be a significant catalyst in building momentum behind DC pension investment into private capital funds.

The Expert Panel supports the Government's intended direction of travel on this, and hopes to engage with it further on how a scheme can be most effective. Below are overviews of various schemes already in place in the UK and overseas to encourage more domestic pension investment into private capital funds and assets. These are followed by recommendations regarding the design of any such scheme.

Recommendation

The Expert Panel recommends that:

As the Government explores the creation of new vehicles or schemes to facilitate pensions investment in high growth companies, it should draw learnings from domestic and overseas precedents (including the French Tibi scheme).

Long-term Investment for Technology and Science (LIFTS)

First announced in 2022, the LIFTS initiative intended to encourage UK institutional investment, in particular from DC pension funds to support the growth of UK science and technology firms. As part of this initiative, the UK Government committed up to £250m to support the successful proposals.

The LIFTS initiative had three core objectives:

- Unlock UK institutional investment particularly from UK DC pension schemes to provide domestic capital for productive investment.
- Catalyse investment into UK science and technology scale-ups at later stages.
- Stimulate the UK VC ecosystem through the provision of domestic

A call for proposals was formally launched in 2023 where investment proposals were assessed against a criteria covering; appropriate fund/structure that meets the needs of institutional investors, long-term support from UK institutional investors, in particular DC pension schemes, the effective use of government support and ESG considerations.

The UK Government formally announced the winners of the LIFTS competition in March 2024, which will see the creation of two new investment vehicles accessible to pension funds.

- Schroders Capital will receive £150m from the BBB to invest into UK science and technology companies, through the launch of an LTAF. This will be matched by a £150m investment from Phoenix Group.

- ICG will receive £100m from the BBB to invest into UK life sciences companies. This investment will also be matched by Phoenix Group.

In July 2024, Schroders and Phoenix Group announced Future Growth Capital, a joint venture with an initial fund worth £1bn. As part of this initiative, Phoenix Group intend to allocate 5% of its relevant savings products, increasing its investment to £2.5bn over a 3 year period.

Government initiatives

Various government-led initiatives have been implemented to facilitate investment from pension schemes and other investors into private capital, in the UK and overseas. These offer learnings for a new UK initiative for investment in high growth companies.

British Business Bank investment vehicle or "Growth Fund"

The BBB has announced its proposal to establish a new fund for pension schemes and asset managers to invest in UK growth companies. This investment vehicle intends to establish the BBB as a point of access for pension funds to invest into venture capital funds, providing a credible source of investment drawing on the BBB's expertise and a permanent capital base of over £7bn.

In July 2024, the Government confirmed that the BBB's work to mobilise the UK's deep pools of institutional capital will fall under the scope of the National Wealth Fund. The BBB investment vehicle would be a welcome addition to the market and provide an important route for investment.

National Wealth Fund

The UK Government has announced a National Wealth Fund (NWF) to drive investment in future industries, with immediate action to align the UK infrastructure Bank (UKIB) and the BBB under a new fund.

Chaired by the Green Finance Institute, a dedicated taskforce has been convened, which includes financial leaders from major institutions to attract private investment and generate taxpayer returns.

An additional £7.3bn (in addition to the existing UKIB funding) will be allocated to UKIB to stimulate investments in priority sectors and the BBB will undergo reforms to leverage institutional capital for the UK's green and growth industries.

The fund will also work with local partners to support regional growth, with new legislation planned to establish the NWF as a permanent fixture in the UK's economic landscape. The NWF has been welcomed by industry leaders as a means to foster public-private collaboration and accelerate sustainable economic growth.

Private Intermittent Securities and Capital Exchange System (PISCES)

Intended to drive innovation and ensure the London Stock Exchange is an attractive listing regime for UK and international companies, the UK Government proposed the creation of a new regime to enable intermittent trading in private company securities.

The PISCES regime, announced in July 2023, sought to provide liquidity and an effective market for companies pre- initial public offering (IPO). The proposals intend to introduce and establish a secondary market for private companies, providing similar legal and regulatory protections as those found on the public capital markets. This includes increased protections for investors and liquidity options for existing investors.

Institutional and professional investors, including pension funds, are the intended audience for the PISCES regime, which seeks to increase investor access to some of the most innovative private companies. Further engagement from Government and the FCA on the development of the proposals is expected later this year.

German WIN fund

To increase access to capital for early-stage, innovative technology companies, the German Federal Ministry of Economic and the Ministry of Finance has launched a WIN initiative (Initiative for Venture and Growth Capital for Germany).

Formalised by a committee of experts and led by the German state-owned development bank KFW, the WIN fund was launched to be Germany's equivalent to the French Tibi scheme, with the German Government outlining a commitment to invest €1.75bn in public funds, matched by €1.75bn of private funds. Germany's largest pensions fund, Bayerishe Versorgungskammer (BVK), Deutsche Borse, Deutsche Bank, Allianz, BlackRock and Dekabank are all proposed to participate as part of the initiative.

Government initiatives

Various government-led initiatives have been implemented to facilitate investment from pension schemes and other investors into private capital, in the UK and overseas. These offer learnings for a new UK initiative for investment in high growth companies.

French Tibi Scheme

The French Tibi scheme was introduced to increase market engagement and participation of French institutional investors (i.e., large insurance companies, asset managers, private pension schemes, global banks and Government-backed banks/investors) and position France as the leading technology investment system in the European Union.

The scheme sought to stimulate the growth of the French late-stage, tech funds and the long-term investment available to private and public French technology companies. In 2020, institutional investors pledged to invest €6billion over three years. The scheme was extended in 2023, with an increased commitment to provide an additional €7billion over the course of the next three years.

The French Government is responsible for co-ordinating the assessment and qualification process for funds to participate in the scheme and includes an Executive Committee (including representation from the Ministry of the Economy and Finance and Bpifrance, the French public sector investment bank), an Unlisted investment Technical Committee and a Listed Investment Technical Committee.

The French tech ecosystem received nearly €30billion of investment over the course of the first phase of initiative between 2020-2022. As of May 2024, the number of institutional investors participating in the Tibi scheme has increased from 21 to 35.

92 unlisted venture capital and growth equity firms have received approval since the launch of the Tibi scheme, including:

- 53 late stage funds (including 15 first-time)
- 37 early-stage funds (including 7 first-time)
- 2 secondary funds (including 1 first-time)
- 43 generalist funds
- 34 deeptech funds (including 16 health funds)
- 13 ecological/energy transition funds, including 3 impact funds

Potential UK Tibi scheme

The Labour Party, while in opposition, outlined its intention to establish an opt-in scheme for DC pension funds to invest a proportion of assets alongside the British Business Bank into UK growth assets. This scheme, modelled on the Tibi initiative, intended to focus on facilitating investment into venture capital and small cap growth equity and infrastructure.

The proposals included an accredited list of UK venture capital and small cap funds, managed through British Patient Capital. An oversight committee, formed from private investors, would be tasked to manage the scheme.

Institutional investors would be asked to allocate a small proportion of funds to the scheme but with discretion over which funds to invest in from the accredited list.

The proposals also included addressing broader barriers to DC pension scheme investment. This included ensuring collaboration between accredited VCs and institutional investors on innovative DC-centric fee arrangements. This considers that that there is a strong incentive for VCs to engage on this given the increasing size of DC schemes.

The proposals also included addressing broader barriers to DC pension scheme investment. This included ensuring collaboration between accredited venture capital firms and institutional investors on innovative DC-centric fee arrangements. This considers that that there is a strong incentive for venture capital firms to engage on this given the increasing size of DC schemes.

Government initiatives

To increase the likelihood of success, Government-supported investment schemes or vehicles should be carefully designed in consultation with industry and underpinned by senior Government sponsorship.

Key considerations for a new Government-supported vehicle

The development of a new Government-supported vehicle should draw on the learnings of existing Government-supported schemes and vehicles which has sought to facilitate greater investment from institutional investors, in particular DC pension schemes into private capital funds. However, a new vehicle should be developed and tailored accordingly to the UK market and take the following considerations into account:

i. Senior Government leadership – the convening power of the French President is cited as a critical reason for the success of the French Tibi scheme securing the participation of French institutional investors. The development of any UK initiative must be underpinned by the personal commitment and close involvement of a high-profile Government figure to secure the participation of large, UK institutional investors and venture capital and growth equity firms.

ii. Broad UK institutional investors base – catering to the various requirements of a wide range of UK institutional investors in order to achieve scale and a level of investment in UK companies that reflects the opportunity, should be a key area of focus for the Government. This should include full range of UK pension arrangements, including LGPS, UK corporate DB schemes (potentially also via the Pension Protection Fund), UK DC schemes and UK insurance companies, which may each require different approaches or parallel schemes/ vehicles.

iii. Geographically broad investment policy focused on developing the UK investment ecosystem –to ensure the diversification and enhance returns for UK pensions schemes, venture capital and growth equity funds should not be required to invest 100% of the funds managed into UK companies. The requirement of UK-only investment would not necessarily achieve the aim of increase UK pension investment in UK companies. The aim should be to build the UK as a hub of expertise for investing and growing innovative businesses across Europe/globally, which will boost the growth of UK companies through domestic bias (around 50% of UK managed private capital is deployed into UK companies) whilst fostering the diversification sought by UK pension schemes.

iv. Focus on the scale-up gap –to support companies that have reached the scale-up stages of investments where there is a significant investment gap in the UK, a new vehicle should focus on developing the UK's investment ecosystem for investment at this stage. It will be important for close coordination with the BBB on its ongoing work to develop the Growth Fund to avoid duplication and ensure cohesion of investment vehicles across the ecosystem

v. Simple accreditation process – building on learnings from the French Tibi scheme, a UK scheme should have a simple, industry-led accreditation process, independent from Government, to give DC investors confidence in the assets and funds included within the scheme. This should follow a principles-based approach and could drawing on the BBB's expertise in due diligence and assessment of fund managers and products. This should also provide DC provers with some level of comfort on their investments.

vi. Bespoke legislative framework – to ensure compatibility with the UK market, a UK scheme may require bespoke legislative and regulatory framework to provide comfort for UK investors to become comfortable with illiquid, private capital assets and overcome hurdles in existing rules e.g., FCA authorisation or state aid rules.

Market infrastructure

Market infrastructure: overview

The Expert Panel agreed that life insurance platforms are likely to remain a key feature of the market infrastructure for Master Trust investment. It also acknowledged that there were challenges in using life platforms for investing in private capital. Whilst platforms had begun offering certain options through LTAFs, further steps could be taken to mitigate those challenges.

The Expert Panel and the TEG looked closely at how the challenges posed by the current market infrastructure could be mitigated, and identified three key potential solutions for increasing DC investment in private capital both by maximising the potential of the existing market infrastructure and making targeted rule changes where necessary:

1. Maximise the potential of LTAFs: by encouraging the FCA to amend the regulatory framework relating to distribution of LTAFs, and by highlighting LTAF versatility and the option for private capital firms to launch LTAFs using "host AFMs".
2. Maximise the potential of the hybrid/custodian model: by highlighting its ability to facilitate DC scheme investment in private capital assets using a separate custodian arrangement whilst continuing to invest in other assets through a life platform.
3. Amend regulation (the FCA's 'permitted links' rules): to facilitate platform investment in a wider range of existing private capital vehicles other than the LTAF, by excluding DC default schemes from the scope of the permitted links rules or including specific, existing private capital fund types as 'conditional permitted links'.

Barriers to investment
(Report to the Pensions & Private Capital Expert Panel – February 2024)

The Expert Panel recognised the need to assess the current market infrastructure used by DC pension schemes to invest into private capital funds. This included a specific focus on life insurance platforms and the role of private capital structures such as the Long-Term Asset Fund (LTAF) as a vehicle for pension fund investment. The Expert Panel and Technical Expert Group explored several barriers as part of a dedicated section on Market Infrastructure which focused specifically on:

The challenges in the use of unit-linked products and life insurance platforms and the alignment of DC assets with private capital investment structures.

The assessment of existing structures and the additional layers of retail focussed regulation associated with the use of life insurance platforms and the need to establish greater understanding of the role and alignment of limited partnership structures to facilitate investment, specifically the LTAF.

Progress so far
(Pensions & Private Capital Expert Panel – Interim Report - September 2024)

This interim report provides the following explainers and recommendations:

Private capital investment through and outside of life insurance platforms – assessing the characteristics of structures used for pension schemes investment and how hybrid/custodian models can facilitate private capital investment.

More options for life platforms via amendments to the permitted links rules – demonstrating the options for reform that could increase investment from DC defaults investing via platforms into private capital funds.

Maximising the potential of LTAFs, by targeted changes to the relevant regulations to help achieve scale.

Next steps
(Pensions & Private Capital Expert Panel – Final Report & Recommendations – Q1 2025)

Further engagement with the FCA on regulatory challenges in relation to:

- The permitted links rules
- Rules around the wider distribution of LTAFs
- The LTAF authorisation process, for host AFMs in particular

Further market awareness raising of:

- The host AFM model
- The hybrid platform/custodian model

Maximising the potential of LTAFs

The LTAF is part of the solution but its potential for private capital investment by DC default schemes using life platforms is not currently being maximised.

The LTAFs and the Panel's objectives for maximising their potential

The Long-Term Asset Fund (LTAF) is a relatively new UK authorised fund vehicle designed by the FCA, with industry input, to facilitate greater investment in illiquid assets from DC pension schemes and certain retail investors.

The Expert Panel believes that the LTAF can play an important role in achieving ambitions of the Mansion House and Investment Compacts and is encouraged that a variety of firms has now established a total of seven different LTAFs targeting different types of investor and with different investment strategies, with more expected. The Expert Panel believes that the use of LTAFs to improve retirement outcomes by investing savers' capital in private capital could be increased if:

i. LTAF capabilities are more widely understood in the market, to drive demand; and

ii.certain aspects of the rules relating to LTAFs are changed, especially to foster scale.

Why LTAFs are an important piece of the puzzle

LTAFs already have potential for facilitating DC scheme investment into private capital, because they:

- already have an established framework that firms are starting to use;
- can be used to build multi-asset private markets strategies (across e.g. real estate, infrastructure, private equity, venture and credit) without direct investment;
- can be used for pooling funds with other funds to achieve scale and diversification;
- provide regulatory comfort to DC because they are UK-authorised;
- provide liquidity comfort to DC because they are open-ended (albeit with restrictions); and
- are explicitly compatible with life platforms by virtue of explicit designation as a 'conditional permitted link' under FCA regulation.

What is holding the LTAF back from its full potential?

DC awareness: General awareness of the LTAF is growing amongst DC schemes. Yet there remain perceptions that LTAFs are primarily suited to multi-asset illiquid strategies and 'funds of one' (where a single investor's capital is not mixed with others'). This may inhibit their use for dedicated venture, growth or buyout strategies and as vehicles for pooling a DC scheme's capital with capital from other DC schemes, thereby limiting scale.

Private capital awareness: There also has been less interest so far in LTAFs amongst specialist private capital firms, which dominate large scale deployment into private capital opportunities. This may be because they do not typically have the required infrastructure, authorisations or product expertise to offer LTAFs to DC investors, and the commercial rationale for allocating resources to developing this seems difficult to establish in a global fundraising market, especially for firms focusing on the smaller venture capital and growth equity markets.

Regulation: There are also regulatory barriers which are hindering some efforts to launch single LTAFs that are accessible to a wider range of capital than DC default schemes, principally self-select and individual private wealth investors. The FCA rules provide sufficient flexibility for Non-UCITS Retail Scheme (NURS) products (commonly used by some DC and notably wealth management capital) to invest in illiquid assets whilst restricting how far they can invest in private capital through LTAFs. This unnecessarily restricts the scope for LTAFs to raise capital from such common NURS funds, making it harder for LTAFs to achieve scale via pooling. The self-select rules also make it difficult to commingle self-select with default capital, again limiting an LTAFs scale.

Maximising the potential of LTAFs

Maximising the LTAF's potential requires: greater awareness of LTAF versatility among DC schemes; greater awareness of the host AFM model among private capital firms; and further changes to distribution rules.

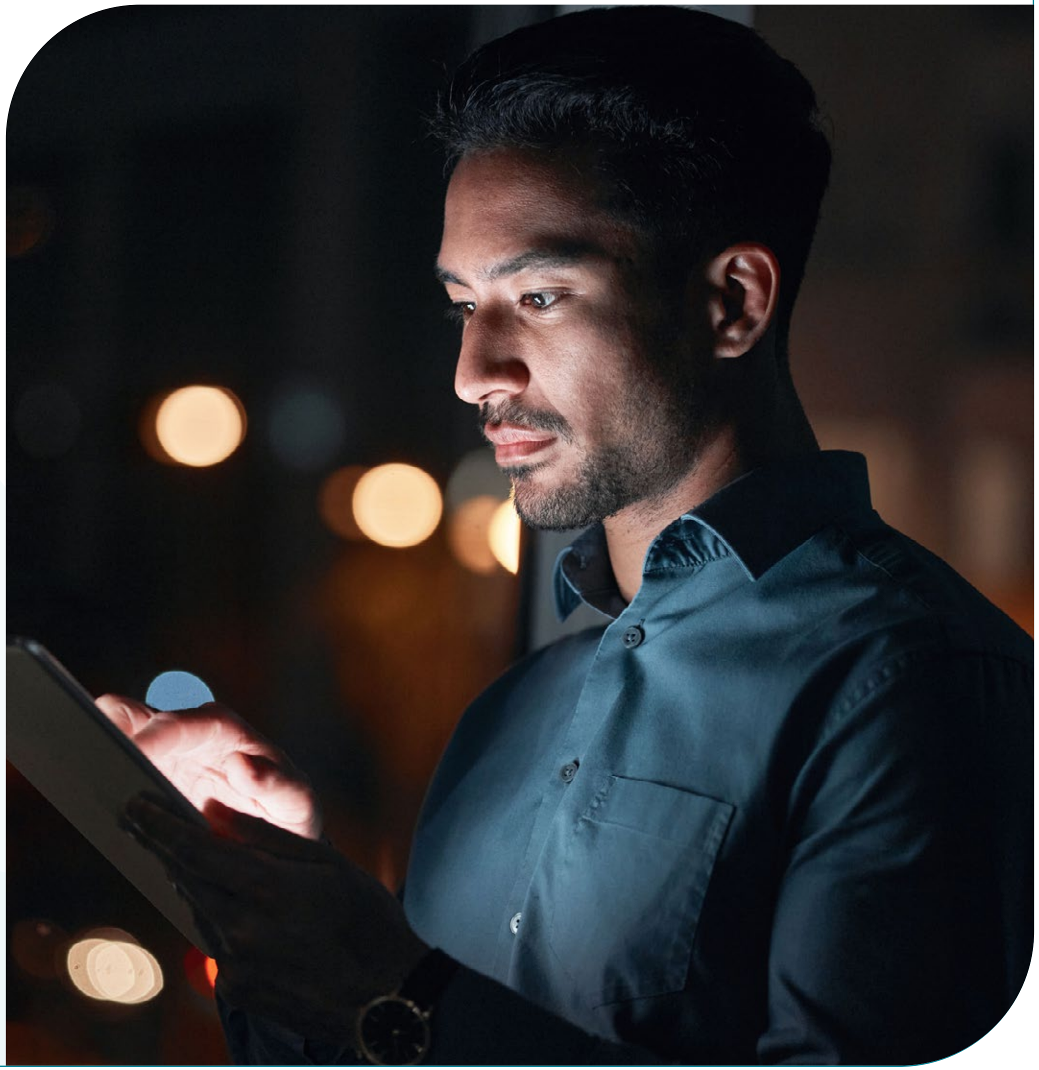
Raising DC awareness of the LTAF's versatility

The Expert Panel believes further steps could be taken to ensure that LTAF capabilities are more widely understood in the DC market. There are different ways that different types of DC scheme can use LTAFs, such as for multi-asset illiquid strategies or for 'funds of one' (through which a single DC investor can pursue a bespoke strategy). Greater awareness could facilitate the use of LTAFs for dedicated private capital strategies such as venture, growth, buyout or credit (rather than multi private markets strategies), and as vehicles for pooling a DC scheme's capital with capital from other DC schemes or indeed other types of investor.

Raising private capital awareness of the host-AFM model for offering LTAFs

The TEG identified commercial providers of "host" authorised fund management services that potentially make this avenue worthy of greater consideration by private capital firms, which typically lack the relevant FCA permissions to manage LTAFs. Different structures will be appropriate for different firms and investors in different circumstances, but there may be scope for an awareness-raising exercise amongst private capital firms as regards the possibility of launching LTAFs using host AFMs. Although, unless further "host" AFM providers develop the capabilities to offer this solution, the existing service providers in this space could become resource constrained relatively quickly

From a practical angle, under this model the AFM service provider has regulatory responsibility for operating the LTAF and ensuring it complies with regulation. The private capital firm acts as the delegate portfolio manager. This means that the product compliance work is carried out by the AFM, which needs information from the manager to discharge regulatory requirements and be confident of its own compliance (the AFM may be viewed as a service provider but from FCA perspective this is the service provider's fund).



Maximising the potential of LTAFs

Targeted FCA amendments to distribution rules for LTAFs

A post-implementation LTAF review was a recommendation drawn from industry discussions at the Mansion House Summit in October 2023. A full review is important once enough experience has been gathered by the market, but the clear priority should be to re-visit the rules in other aspects of the authorised fund framework that affect LTAF viability, and the authorisations process, in particular:

i. NURS rules: The FCA should amend the NURS rules to facilitate NURS investment in LTAFs, and the consultation on this topic launched on 6 September is welcome. This would help LTAFs pool capital from investors that use NURS vehicles (e.g. DC and retail capital). It would:

- Bolster the commercial rationale for firms to establish LTAFs by increasing the addressable market of potential investors beyond DC (i.e. increase the opportunity).
- Broaden DC investors in NURS ability to benefit directly from greater private capital exposure (where DC capital already invests through NURS, they would gain exposure through underlying LTAFs), subject to proper assessment of savers' best interests.
- Broaden DC investors in LTAFs ability to benefit from the pooling of DC default capital in the same LTAF alongside capital from NURS funds, which could incentivise more managers to establish LTAFs (i.e. increase competition/ choice for DC investors); promote economies of scale; and help diversify risk (because the DC default capital would be exposed to a larger number of investments in smaller proportions).

iii. Self-select rules: For similar reasons, the review should also consider whether the rules governing self-select allocations in a trust-based environment should be simplified to level the playing field between NURS 'FAIFs' and LTAFs as regards illiquid asset allocation. This will involve re-visiting the interplay with the new 'RMMI' rules and the Consumer Duty.

Recommendation

The Expert Panel recommends that:

The FCA should make targeted changes to the relevant regulations so that investor access is not unduly restricted and to encourage more LTAFs to come to market.

Maximising the potential of the hybrid/custodian model

Life insurance platforms are the most widely used structure by Master Trusts and GPPs for investing DC assets. They are subject to permitted links rules which place restrictions on the level of investment that can be made in illiquid assets. Some Master Trusts use Custodians that are not subject to these restrictions. A 'hybrid' model can provide elements of both approaches, provides greater flexibility and should be explored.

Introduction

DC benefits are provided either via a Trust base or contract base via a contract with an insurance company. Contract-based DC schemes as a result are an insurance product, provided by insurers and delivered on a 'Life Platform'. Trust-based schemes can be delivered by a Life Platform ('on platform'), a Custodian ('off platform'), or a combination of the two (a 'hybrid'). These form the space in which the pension savings and assets are administered, they also provide the 'tax wrapper' for the pension (so that it benefits from the tax treatment assigned to pensions) and they manage the buying and selling of the investments. The approach used has an impact on easily a pension provider can invest in private capital and how that investment is made.

Maximising the potential of the hybrid/custodian model

Different types of model (see Appendix 2 for further detail

Barriers to investment

Life Platforms are operated by insurers, but they are not exclusively used by insurers. Some pension providers (which are not part of a wider insurance organisation) use life platforms.

Insurers can invest in 'insured funds', also known as unit-linked funds. Unit linked funds are insurance policies (known as 'linked long-term contracts of insurance') in which the member's pension contributions are used to purchase units in funds, and the value of the units will change directly in line with the performance of the investments held within the fund(s). The beneficiary of the policy is the member but the assets held on the Life Platform are owned by the insurer.

Unit linked funds are insurance policies, and as a result are subject to FCA 'permitted links' rules on insurers, which specify the types of investments that insurers can make, specifically in this context the amount of illiquid investments in their default fund (see next page for more details).

A significant portion of the DC market1 is currently provided via Life Platforms (this includes the majority of the contract-based GPP market and a number of the larger Master Trusts, e.g. L&G, Aviva, Scottish Widows, Phoenix (Standard Life), Aegon, Fidelity, Aon).

Custodian

A custodian is a third party that has 'custody' of the assets of a pension scheme, and they are independent of the pension provider. Some providers are established names within banking and asset management such as BNY Mellon, HSBC, JPMorgan, Northern Trust and StateStreet.

A custodian acts as the asset administrator holding assets directly on behalf of the pension provider and trustee. The custodian is able to produce a daily valuation of the assets and unitise them so that each member can have their own account.

Custodians are regulated by the FCA but they do not use contracts of insurance and as a result they are not regulated by the PRA or subject to the 'permitted links' rules.

As a consequence users of custodians can invest with fewer restrictions in illiquid assets relative to life platforms

Hybrid

An alternative offering is a model that provides features from a Life Platform and a Custodian, known as a hybrid. These have only recently started to be used at scale in the DC pensions market. and have been growing in profile, but at present we understand there is only one provider, Mobius Life.

A hybrid provider is an insurer and regulated by the PRA, in doing so they provide 'on platform products' and also provide the fund administration for assets of clients held outside of the life platform, 'off-platform', similar to the service provided by a custodian.

The hybrid platform combines the valuations of the assets 'on' and 'off' platform into notional funds and accounts administered on behalf of the customer.

Maximising the potential of the hybrid/custodian model

Over the medium and long term there may be greater consideration of the benefits of alternative models such as a Custodian model and Hybrid solutions, particularly as providers increase in scale and competition.

Observations and perspectives	
Life Platform	• Life platforms are currently the most prevalent in the DC pensions market, they typically have scale, are part of well-established business and benefit from the controls environment of a regulated insurer, and as a result likely to form a core part of the market for the foreseeable future. There is an added commercial incentive for Master Trusts to continue to use a life platform where those Master Trusts are part of a larger insurance company. • Ensuring there are efficient mechanisms in place for Master Trusts that use life platforms to invest in private capital will be important in order to achieve a material increase in the amount of pension assets invested in private capital. Life platforms already offer a degree of flexibility particularly via the LTAF and other vehicles that are conditional permitted links. • Although a relatively new type of vehicle, the use of LTAFs is gaining momentum. LTAFs are likely to be a part of a range of measures used to invest in illiquid assets/private capital. • The permitted links rules that life platforms are subject to mean that some Master Trusts cannot invest in private capital to the same extent as those Master Trusts that use a custodian platform. This may mean that the comparative level of commercial opportunities are restricted, such as co-investment programmes. • A change to the permitted links rules governing life platforms could help facilitate greater investment in private capital.
Custodian	• Custodians are not subject to the permitted links rules and certain other regulatory protections (e.g. FSCS) also do not apply. • Compared to life platforms the customer is closer to the asset that is owned, e.g. it is less intermediated and as a result may have greater visibility of the asset. • Without scale Custodian models can be relatively more expensive than life platforms, but they become more efficient and broadly comparable where users have the size to deliver the benefits from economies of scale.
Hybrid	• In a hybrid structure the bulk of a scheme's assets remain under a regulated, Life Platform structure while a broader range of assets/funds such as private capital can be held outside the Life Platform but included in the overall pricing mechanism. This enables Life Platforms to integrate private capital assets into a UK DC portfolio. • This structure is less established in the market than Life Platforms and Custodians, but hybrid offerings potentially a middle ground that offers features of both models.

Next Steps

As the DC market grows, the choice of structure may have a more meaningful impact on the quality, flexibility and competitiveness of the service that can be provided to employers and members, and this may drive further innovation and change. In the short term, maximising the flexibilities and functionality of the existing structures can continue to benefit the market and we recommend that stakeholders ensure they are aware of the benefits and features of each. The market should be encouraged to evolve and innovate to meet growing demand for greater exposure to private capital assets and funds, in particular as regards the hybrid model.

Amending regulation to increase vehicle options

Further reform to the FCA's permitted links rules would give DC default schemes investing via life insurance platforms access to a wider range of private capital products.

Private capital funds are excluded from platforms by permitted links rules

The Expert Panel explored the role of the current Permitted Links rules on DC investments. The rules set out restrictions on the extent to which insurance companies can invest in illiquid assets. Because of the significant role life insurance platforms play in the provision of DC pensions, these rules have a big impact on the ability of most DC pension schemes to access high-performing private capital investments.

Although greater use of LTAFs and the custody (or hybrid) model would increase DC investment in private capital, any such increase alone seems unlikely to be sufficient to meet the Mansion House Compact commitments. LTAFs also seem to be 'captive' in some cases, only offering an insurers' schemes access to the same insurer's LTAF, potentially limiting investment opportunities for underlying investors. They also typically have lower returns targets than other commonly used private capital fund structures and need to retain liquidity in multi-asset structures that can cause a drag on returns.

The Expert Panel also noted that specialised private capital firms, who can evidence track record and continue to provide widest market access to private capital investment for institutional investors around the world, have already established fund structures and supporting infrastructure in other jurisdictions and are unlikely to use LTAFs at scale in place of or alongside fund vehicles typically used by non-UK DC investors globally (usually unregulated limited partnerships).

This is because LTAFs differ from typical private capital funds because they are FCA-authorised vehicles with a significant amount of product regulation. They require different expertise to that required for managing the unregulated, institutional funds that dominate the private capital investment landscape. This means that:

1. Smaller private capital firms, such as those focused on venture strategies, typically lack the requisite scale to support the product expertise required to manage an LTAF (venture investments are usually minority stakes in small companies).

2. For larger firms, the commercial rationale for investing in the operational capacity to manage LTAFs for UK DC schemes alone can seem weak in the context of a global fundraising market where pension and other investors around the world can generally invest in a pool via an unregulated limited partnership that is cheaper to run, is well understood by the market, and has underpinned the industry's returns track record for decades.

Recommendation

The Expert Panel recommends that:

The FCA should review and amend the permitted links rules.

Life insurance platform providers look to expand private capital options for DC schemes.

The Expert Panel's discussions concluded that, due largely to the permitted links rules, life platforms currently cannot easily channel UK DC default capital into most of the structures that established firms specialised in private capital investment typically use to pool and invest capital from global investors. This includes non-UK vehicles increasingly offered by private capital firms to a range of investors that can be semi-liquid and are often subject to EU product regulation similar to the UK's LTAF rules, as well as the common limited partnership structures. These often have higher returns targets than LTAF products, so widening DC investment vehicle options to include these more proven structures could support the objective of increasing savers' potential returns. These often have higher returns targets than LTAF products, so widening DC investment vehicle options to include these proven structures would support the objective of increasing savers' potential returns.

However, the Expert Panel also recognised that the landscape, including regulatory expectations and those of savers, is moving quickly. It noted the significant role platform providers play and, though it is clear that many have improved, and continue to, improve the range of investment options, it was keen that platform providers continue to act with urgency in improving access to private capital investment opportunities. In addition, the Panel encouraged regulators to continue to monitor this landscape and, if progress remains slow, to consider further regulatory interventions.

Amending regulation to increase vehicle options

There are two options for reform that could greatly facilitate DC investment into private capital funds via life insurance platforms.

Overview of issues with the current permitted links rules

The current rules enable DC pension schemes to access LTAFs because they are explicitly included as a 'conditional permitted link'. This means they are not subject to a cap on illiquid assets. This creates certainty for insurers and pension scheme trustees that LTAFs are compliant.

For other types of funds, the situation is less straightforward. Under the permitted links rules, UK authorised qualified investor schemes, or EEA equivalent funds, can qualify as conditional permitted links, provided they invest in other conditional permitted links. Therefore, to make these types of common private capital fund available on life insurance platforms, the insurer must undertake due diligence on the fund and its investment portfolio to ascertain if the underlying investments qualify as (conditional) permitted links. This is a burdensome process and can involve elements of judgement on some matters. Furthermore, these funds are subject to the 35% cap on investment into professional investor funds ('qualified investor schemes') and other conditional permitted links.

The options for reform

The Expert Panel considers that there are broadly two options for broadening private capital investment options for DC default schemes that use life platforms by amending the permitted links rules.

1. **Excluding DC pension schemes default funds from the Permitted Links rules:** From a broader policy perspective, the Expert Panel believes this change would be appropriate because DC schemes are professionally managed by trustees, and with a legal obligation to seek professional investment advice – they are not retail funds. This would also ensure a level playing field with DB schemes, which are not subject to such restrictions. This could result in a wider range of private capital investment options being made available to DC schemes via platforms. However, the Expert Panel recognised that Permitted Rules are complex and that any unintended consequences would need to be assessed carefully.

2. **Including more private capital fund structures as 'conditional permitted links'.** As an alternative, it may be quicker and more straightforward to treat other commonly used private capital investment vehicles in the same way as LTAFs are within the rules. Private capital firms have recently been launching a range of semi-liquid, regulated vehicles whose inclusion as conditional permitted links would seem to be a natural extension to including the LTAF. The criteria for this approach to a particular type of vehicle would need to be developed further by the FCA. One consideration to explore might be whether a candidate vehicle is subject to product regulation in another jurisdiction.

Next steps

The BVCA and TEG will explore these options further with the FCA over the coming months and provide an update in the final report of the Expert Panel in 2025.

Liquidity

Liquidity: overview

Liquidity management is an important consideration for any investor allocating to illiquid private capital funds. UK DC schemes have particular considerations in relation to liquidity management, which the Expert Panel considered in detail.

This has been an area of focus for the Productive Finance Working Group which produced a guide to liquidity management at a scheme and underlying fund level. Despite this, concerns over liquidity management in the event of a one-off liquidity event or bulk-transfer, though rare, may act as a disincentive for DC pension schemes to invest in private capital funds.

Barriers to investment
(Report to the Pensions & Private Capital Expert Panel – February 2024)

The Expert Panel recognised the need to assess how the time horizon for pension members fit in with the time horizon and liquidity characteristics for returns from private capital. The need for additional reassurance by regulators on how schemes should handle potential liquidity events.

The Expert Panel and Technical Expert Group explored several barriers as part of a dedicated section on Liquidity which focused specifically on concerns of a one-off liquidity event or bulk transfer (where an employer moves from one Master Trust to another), which might provide a disincentive for DC pension schemes to invest into private capital.

Progress so far
(Pensions & Private Capital Expert Panel – Interim Report - September 2024)

This interim report provides the following explainers and recommendations to address each barrier:

Liquidity management – outlining the importance of liquidity for both DC pension schemes and private capital firms and provide how liquidity can be managed during an unexpected liquidity event.

The need for additional reassurance by regulators on how schemes should handle potential liquidity events.

Next steps
(Pensions & Private Capital Expert Panel – Final Report & Recommendations – Q1 2025)

Building on the work of the interim report, the Expert Panel will report in 2025 on its engagement with regulators on how schemes can have more reassurance in relation to potential liquidity events.

Liquidity management: why it matters to DC

Liquidity management is both complex and important consideration for DC schemes due to structural features of the UK market and its stage of development. Day-to-day liquidity should be manageable of large schemes with significant inflows, like commercial Master Trusts, but large liquidity events remain a consideration.

Introduction

The Expert Panel explored the issue of liquidity, which is both complex and important.

Feedback from the Expert Panel suggested that the scale of DC Master Trusts means that day-to-day liquidity management, and providing individual members with complete pot liquidity, is not a key concern (although this may pose greater challenges for smaller schemes).

However, the Expert Panel identified that the possibility of bulk transfers, perhaps as a result of an employer moving to a new Master Trust, or because of consolidation, is a factor for many Master Trusts when considering default fund liquidity.

The Expert Panel explored how this may be handled, whether this is a matter for Master Trusts to manage, and whether regulatory intervention is required.

Features of the DC pensions industry relevant to liquidity

In relative terms, the DC industry is the less mature part of UK pensions compared to DB. Traditionally, DB followed a wider variety of investment strategies, varying risk and return depending on the circumstances scheme and the strength of the sponsor. DC on the other hand, being smaller, tended to focus on accessible and liquid investments such as listed equities, tracker funds, credit funds and bonds.

There are also a number of structural features of the DC pensions industry which have until recently continued the focus of investments on liquid assets with small allocations (commonly less than 5%) to illiquid assets and therefore the focus on managing liquidity in DC to date has had less focus. Some reasons for the focus on more liquid assets include:

- **The regulation of life insurance platforms:** Life platforms offer DC investors access to a variety of investment options, but they are subject to regulation by the FCA and the PRA and the Permitted Links rules. These aim to protect pension scheme members and have rules around the nature and liquidity of assets.
- **Lifestyling:** This strategy has been used by many pension schemes to automatically adjust the asset allocation of a member's pension pot according to their age and expected retirement date. It typically involves a gradual shift of investments away from illiquid assets, such as private capital, towards more liquid assets, over a number of years in the run up to a member's expected retirement.
- **Transfers:** employers and members have the ability and option to move between providers. Whilst this is not straightforward and switching between providers (particularly in the Master Trust market) is not commonplace, this option is available and would impact the cash flows of a provider, notably the change in cash contribution inflows but also the need to transfer out benefits.

As DC assets under management grow rapidly and there are changes to investment strategies to incorporate less liquid assets there is a growing focus on the management of liquidity. And this is likely to be a key focus of regulators, the FCA and TPR, particularly given the experience of recent LDI liquidity crises in 2022 in the DB market and the failure of the Woodford fund for investors in 2019.

This focus particularly applies to default funds where the vast majority of members and assets are concentrated. In January 2024 TPR published private markets investment guidance that noted ""where illiquid private market investments are incorporated into a scheme's asset allocation, you will need to ensure they do not impact on the ongoing operation of the default strategy".

Over the following pages we highlight some of the considerations in managing liquidity:

- Types of liquidity events
- Factors that influence the occurrence and impact of events
- Different options for managing these events
- Recommendations going forward

Liquidity management

The consensus view from EP and TEG discussions is that the functions to facilitate day-to-day liquidity for trading and operation of a pension scheme, a fund or an asset, are well established, and these are increasingly capable of effective liquidity management where there is scale. The management of liquidity for material or unexpected events is less clear and tested in the DC market.

Examples of liquidity events

Pension scheme e.g. a Master Trust

Managing liquidity is a constant feature of the administration of a pension scheme and managing the obligations to members. There are a range of events that require liquidity which differ in frequency and scale.

- Liquidity in response to individual member events, for example:
  - A transfer out of benefits e.g. to another Master Trust or a SIPP
  - A transfer out to a drawdown provider or to purchase an annuity.
  - Payments required on the death of a member, ill health, divorce etc.
  - Changes between a member's investment strategy and asset allocation, e.g. a move from the accumulation phase to the decumulation phase within the same provider, or a move out of the default fund.
- Investment strategy - Rebalancing of the strategic asset allocation of a portfolio in response to market movements. This is the buying and selling of assets to maintain the target asset allocation and may require liquidity to do so.
- A bulk transfer of members initiated by an employer - e.g. an employer deciding to move from one master trust to another. Note this relates to future contributions, accrued benefits remain with the existing provider unless also transferred which requires the consent of the trustee of the existing provider.
- Consolidation of Master Trusts - infrequent and in most cases can be planned for.
- A trigger event under the Master Trust regulations - e.g. a provider becomes at risk of failure, there is an insolvency event or other cause for wind up (noting that there are also regulatory reserves set aside to cover the cost of these).

Liquidity management

Examples of liquidity events

Private capital fund invested in multiple assets

Individual Private Capital asset

On a business as usual basis liquidity in a fund could be required to:

- manage short-term financing needs before drawing down on cash from limited partners
- pay a management fee to the general partner
- repay any debt held by the fund

At an asset level liquidity depends on the needs of the portfolio company or asset, this could be for:

- day-to-day business purposes such as working capital;
- investment;
- debt service and repayment; or
- paying dividends.

More severe liquidity events at a fund or asset level may be driven by a distressed scenario either driven by features of that business, or macroeconomic events, e.g. an increase in interest rates. These may require more liquidity to be injected into an investment to ensure its stability or to prevent value destruction / leakage.

Liquidity management

Liquidity strategies will be different for each provider depending on factors such as scale, market and investment strategy. Larger providers may be better placed to manage liquidity from inflows and higher levels of member retention. Whilst all providers should stress test their liquidity management plans this may be even more important for smaller providers or at times of cash outflow.

Factors influencing the occurrence and impact of liquidity events

How liquidity events occur and impact providers will differ depending on their own features and characteristics. For example:

Scheme level

- The overall level of exposure to illiquid assets and the type of investment invested in - open-ended, close ended, fund of funds, direct investment.
- Providers who have a 'sticky' or young membership may have fewer transfers out, death or ill health payments, and movements from accumulation to decumulation.
- Providers who have a higher number of active members providing regular cash inflows may find that they are able to 'offset' cash outflows with these inflows, effectively trading between individual buyers and sellers within the pension scheme to reduce divestments. However the extent to which providers feel they can rely on these inflows and for how long will differ.
- A provider that has a large number of small employers may be less impacted by the decision of an employer to switch provider. A provider with a higher concentration of large employers may be more materially impacted in this case. If there is further consolidation in the market - providers may find that liquidity is less of an issue where all providers have a large number of employers.
- The investment strategy of a provider - if there is a material market event providers may be impacted differently depending on the sector exposure and level of diversification, and some may need to take different steps that have an impact on liquidity in order to rebalance their portfolios.
- The position and strategy of providers in the DC market - those who are more actively involved in M&A and consolidation may require more liquidity. Another example is where a Master Trust may operate on a different investment platform which is unable to receive a transfer of illiquid assets.
- Over the longer term, a change in regulation or market behaviours that allows and/or facilitates more active switching by employers and or members.

Fund level

- The design of the fund - close ended funds have a set level of investor funds once the fund is closed. Any further liquidity may have to come from raising leverage.
- Open-ended fund - when a fund manager designs the liquidity features of an open ended fund investing in less liquid assets, there is a need to avoid a 'liquidity mismatch' by ensuring the redemption policy of the fund is consistent with the investment strategy and the liquidity profile of the underlying assets. Setting the notice period at a fund level, fund managers will consider the profile of the portfolio as a whole rather than a single asset.

Asset level

- The amount of liquidity needed by a portfolio company will vary by factors such as the capital intensity of the business and working capital cycle, the amount of investment required, its debt profile and the profitability of the business and its cash generation.
- Transacting in less liquid assets, such as realising liquidity through a sale requires significant time and resources.

Liquidity management

Pension providers have a fiduciary duty to act in the best interests of their members and ensure that there is the resilience to manage a significant and sudden liquidity event, particularly with regard to the default arrangement. As illiquid asset allocations increase these will become increasingly important.

Options for managing liquidity in unexpected events or stress scenarios

Option		Comment
Scheme		
	Gating	This limits or prevents redemptions of an investment. Where this applies to a default fund, which is the home for a significant number of members (90%+), this may be undesirable, particularly if it impacted members who wished to transfer out or those approaching retirement and wanting to take their benefits. The need to gate and prevent redemptions may have a reputational impact on a provider, and whilst gating may provide a means of providing a better outcome for a member over a particular time period this may not be understood by members who want to access their funds, and trustees may only want to use gating as a last resort option.
	In specie transfers	In specie transfers of assets - this is the transfer of assets in their underlying form, rather than units in an investment fund. Transfers of this nature can take time and are complex, and from discussions with the EP and TEG it was often noted that a receiving provider may not wish to take on certain assets if they are not considered a good fit with their strategy and offering, particularly if these are small investments. Taking on an asset will require due diligence and have time and cost implications. This may become even less desirable where there is an increase in the reporting of performance metrics between pension providers, such as net returns, cost and other factors such as ESG, if the obligation to take on assets has a negative impact on these metrics.
	Secondary markets	The secondary market for private capital can play an important role in being able to provide liquidity to investors who need to sell stakes in a fund. It is generally a 'buyers' market' with sellers usually focused on a quick sale and more accepting of a discounted price to the carrying value of the asset.
Fund		To create liquidity a Fund may borrow using its stakes in portfolio companies as underlying collateral (net asset value financing). It could also create new preferred equity classes in a distressed scenario if it is difficult to attract additional debt. Limited Partner consent is likely to be required if preferred equity is added, and existing investors may be invited to participate in the new class before other investors.
Asset		Private capital assets as described in this report, primarily venture capital and growth equity are 'cash intensive' due to the investment required in the expansion, growth and working capital needs of the businesses that they are invested in. There is little surplus liquidity and transacting these assets is complex. If an asset (e.g. a portfolio company) requires more liquidity it may look to raise debt or further capital depending on the funds' governing agreements, agreements with other investors and leverage limits. However, this may be expensive if the business is in a growth phase where is has not yet established a track record of performance.

Liquidity management

Pension schemes should take steps to carefully manage liquidity, and regulators could act to provide additional reassurance on handling liquidity events.

Investing in illiquid assets has additional risks compared to liquid assets and as a result illiquid assets provide the opportunity to benefit from an 'illiquidity premium'. The risks can be minimised and mitigated but not always removed. DC schemes are rapidly growing and to an extent can rely on cash inflows from contributions to meet liquidity needs ('offsetting'). However, the balance of inflows and outflows will change over time and it is critical that liquidity management strategies are tested on infrequent downside / shock scenarios to ensure they are robust, and it is a key part of the fiduciary duties of pension providers and trustees to members to do so.

Considerations for DC liquidity management

- Maintaining portfolio balance - maintain liquidity at a scheme level through managing the proportion of private capital investments relative to the overall portfolio, ensuring the portfolio is well-diversified to produce liquidity if necessary.
- Stress testing - scenario plan for rebalancing the portfolio in times of stress, unexpected or material events, and what level of liquidity may be needed.
- Regular review - strategies should be regularly reviewed and revised where there is a significant increase in private capital exposure. As Master Trusts grow in scale, greater analysis of member behaviour is likely to enable more accurate forecasting of liquidity needs.
- Cash settlement options - In times of stress, TPR has said that schemes should have contingency plans in place to fund any withdrawals from elsewhere in the asset allocation. This may lead to further stresses in the schemes' portfolio and scheme should have specific plans for how this is managed to avoid a series of stresses that have a wider impact on the scheme.
- There are guidelines available to support the design of liquidity strategies - the Productive Finance Working Group liquidity guide and TPR Liquidity Risk Management Plans. We also note that for pension providers that are also regulated by the PRA (insurers) it is already required to have sophisticated risk management controls and practices in place to manage liquidity in times of stress.

Regulatory rules for material events

The Productive Finance Working Group 2022 report offers a lot of information and support to understand liquidity events further. This was written by the industry with support from the FCA and HM Treasury.

The Expert Panel recommends that regulators (FCA, PRA, TPR, DWP) engage with the market to review and further develop the guidance for liquidity management and ensure that this framework is fit for purpose taking into account the growing exposure to private capital in DC and the rapid growth of DC assets, particularly in relation to resilience against shock events. This should take into account the regulatory growth remit and seek to provide reassurance to DC pension schemes that the prospect of bulk transfers should not be a deterrence to investing in long term private capital funds.

Recommendation

The Expert Panel recommends that:

Regulators should work with industry to provide reassurance, and updated guidance, on their liquidity expectations for how DC schemes should handle the stress events and their impact on liquidity.

Next steps

The BVCA will engage with the regulators and industry on the best way to take this recommendation forward.

Wider UK pensions evolution

Wider UK pensions evolution: overview

The pensions sector continues to evolve, both in terms of regulation and the wider market. As this happens, its important that the ability to invest in long term, illiquid investments, such as private capital. It is important that regulators and DC providers continue to consider the long term net returns for members, as the market and regulation changes. This is the case, not just for DC, but also DB and LGPS. Though the issues and landscape differs, the ability of schemes to maximise their investment options should remain a priority.

Barriers to investment
(Report to the Pensions & Private Capital Expert Panel – February 2024)

The Expert Panel recognised the need to **assess the evolution and reform of the UK pensions system** and long-term considerations that could help increase investment into private capital funds.

The Expert Panel and Technical Expert Group explored several barriers as part of a dedicated section which focuses specifically on:

Features from other pension system – consideration of features from other overseas pension systems that could be incorporated into the UK pensions system that would increase DC pension investment into private capital.

Medium to long term considerations – assessment of further existing or emerging options that could be considered in the medium to long term to increase DC pension fund investment into private capital.

Progress so far
(Pensions & Private Capital Expert Panel – Interim Report - September 2024)

This interim report provides the following explainers and recommendations to address each area of consideration:

"To and Through" investing – an outline of how there can be increased opportunity to continue allocating to private capital funds into and through retirement.

Risk pooling and Collective Defined Contribution (CDC) - a long term assessment of the role CDC could play to enable greater levels of investment.

Overseas insights – a comparison of features from overseas pension systems that could provide learnings for the UK pension system.

The broader pensions context – alongside DC pension schemes, the UK pension system also includes Defined Benefit (DB) and Local Government Pension Schemes (LGPS). Consideration of both helps to form the broader pensions context.

Next steps
(Pensions & Private Capital Expert Panel – Final Report & Recommendations – Q1 2025)

Building on the work of the interim report, the final report of the Expert Panel, to be produced in early 2025, **will explore the insights from overseas pensions systems in more detail, and set out analysis of what would work in a UK context.**

‘To and through’

Until recently there has been a trend for members’ investments to be automatically ‘lifestyled’, to reduce exposure to growth assets such as private capital, into more liquid investments as they approach retirement. This trend is being challenged with the belief that there is greater opportunity to continue with an allocation to growth assets into and through retirement to improve returns.

‘A greater role for ‘to and through’?

‘The Expert Panel considered the investment strategies typically by used DC schemes and, in particular, the role of ‘lifestyling’ strategies - which reduce the proportion of investment in riskier and illiquid assets, replacing them with lower risk and more liquid assets, as an individual approaches retirement. This tends to place DC members’ pensions on a reducing growth trajectory from the age of 45. There has been increasing recognition of the detriment of such strategies to individual member pots, especially in light of the changing nature of retirement.

‘To and through’ is an approach to investing whereby savers continue to invest in a proportion of growth seeking assets not only up to their chosen retirement date but through retirement. The challenge is to find a balance that allows pension savers to maximise the benefit from private capital growth assets during the accumulation phase and into retirement whilst also ensuring they have the necessary liquidity and security during decumulation. The Expert Panel considered whether there needs to be a greater role of ‘to and through’ investing, and how this can benefit DC savers by enabling them benefit from long term investments, such as private capital, for longer.

Phases of a DC pension pot

With DB schemes, members contribute into their pension schemes for their working life and the scheme pays money to members during retirement. What this means in practice is that DB scheme providers can take a longer term view in relation to investments and can therefore invest in illiquid investments with longer time horizons.

The DC pension scheme system is different as the period of saving (accumulation) and provision of pension income (decumulation) has been disaggregated.

- **Accumulation:** The phase in which an individual actively contributes to and builds up their pension savings over time. During this time their savings are invested by their pension provider with a view to growing the value of the ‘pot’.
- **Decumulation:** The phase when an individual retires and begins to draw income from their pension savings.

In the King’s Speech of July 2024, the Government announced a new Pensions Bill, which will introduce a requirement for providers to offer decumulation options for members. This also set out plans to address the proliferation of deferred small pots.

‘To and through’

To date drawing income from a pension is typically done through a combination of the following:

- Purchase of an annuity: Insurance product which guarantees a certain level of annual income for life.

- Drawdown schemes: Members are able to keep their pension pot invested while they drawdown money as needed.

- A lump sum - withdrawal of lump sum payments.

For some people, there is clear a crossover point where people switch from accumulation to decumulation and often that means divesting from growth assets into low risk assets such as cash. For others they are continuing to work for longer (e.g. part time or less consistently) and therefore decumulation options need to have the flexibility to accommodate this.

Due to the dual phase approach inherent within DC pension schemes, it is difficult for pension providers to invest in longer term illiquids and private capital in the same way as DB schemes are able to. This is further exacerbated by:

- The introduction of Pension Freedoms in 2015 offered people over the age of 55 more flexibility and choice over how to access their pensions savings. However it can also reduce the incentive for people to invest in long-term illiquid assets since they could withdraw all of their money as a lump-sum at 55, rather continuing to invest into retirement and use a variety of options over time.

- Lifestyling potentially lowers returns for members. It also may not reflect the individual risk preferences or circumstances of members. Lifestyling is usually based on a default assumption of the member’s retirement age and income needs, which may not match their actual plans or goals, and assumes that members will want to convert their pension to cash at retirement (in line with the point above). Lifestyling may also not be compatible with some new investment vehicles and strategies which may provide higher returns over longer time horizons.

As a solution to this the development of ‘to and through’ strategies and a range of decumulation options that can allow members to maintain higher exposure to growth assets during the latter stages of the accumulation phase as well as the decumulation phase. Though the volume of ‘small pots’ may pose a challenge in the short term, the Government taking forward proposals to consolidate deferred small pots will present further opportunities for ‘to and through’ strategies. This change will require innovation by providers, as well as support and guidance from regulators.

Looking forward, two key elements of the Government’s pensions review - investment issues and pension outcomes (including adequacy), are very closely connected. The Government’s work to improve pension adequacy should mean more people approach retirement with larger, consolidated pots, which will increase the impact of ‘to and through’ investing.

‘To and through’

With a requirement for pension providers to provide a range of decumulation options for members there is an opportunity for innovation in how investing throughout retirement is approached. This can lead to greater outcomes for members and greater levels of investment in private capital assets, for longer, into retirement.

Overview of a ‘to and through’ approach

Pre-retirement

Post-retirement

Awareness and understanding of risk: A ‘to and through’ approach can increase the amount of risk in a pension portfolio in retirement. Members are likely to need more education to understand the balance risk vs return of this approach and how this is managed.

A long term view of investing taken in the latter stages of accumulation: Greater allocation to growth assets in the years before retirement can result in a higher pot going into retirement.

Development of more decumulation options (ref 2024 Pensions Bill): Providers will engaged to offer more flexible and personalised investment options that reflect the members preferences, risk appetite and retirement goals.

Continuation of investment in some growth assets throughout decumulation: For some people they will not need to take all of the pension at the point of retirement. Pension pots can continue to produce returns over the retirement phase funding retirements.

Benefits of continuity of provider: Providers that offer both accumulation and decumulation, can ensure that there is a greater linkage between the two phases, and allow DC members to remain invested in their pension scheme with the same provider post retirement. Having a single provider for both accumulation and decumulation have its advantages and disadvantages and may not be the right choice for all. However, having a broader strategy that looks at the entirely of the members journey will be important to optimise the outcomes.

Recommendation

The Expert Panel recommends that:

DC schemes should consider the role of ‘to and through’ investing, with a view to keeping savers invested in private capital investments for longer periods of time.

Risk pooling and Collective Defined Contribution (CDC)

Pension models that enable the pooling of risk have the potential to address some of the challenges of individual DC and could enable a greater level of investment in private capital. CDC is a good example of this, and the industry should be open to exploring new models.

Introduction

The Expert Panel explored the potential for other models of DC that could help the retirement prospects of DC savers, and make private capital investments easier. Pension scheme models with risk pooling aim to retain some of the benefits of a DB scheme which are absent in an individual DC pension arrangement. Risk pooled models are mainly invested in growth assets. It aims to provide a target level of income in retirement for its members, based on the pooled contributions and investment returns of the scheme, however, it does not guarantee any particular level of benefits and there could be adjustments made to the targeted level of benefits depending on the funding and performance of the investments. However, given the pooling of risk across different generations, the expectation is that adjustments to the benefits will be less material when compared to individuals holding separate DC pots. CDC schemes are examples of a risk pooled scheme.

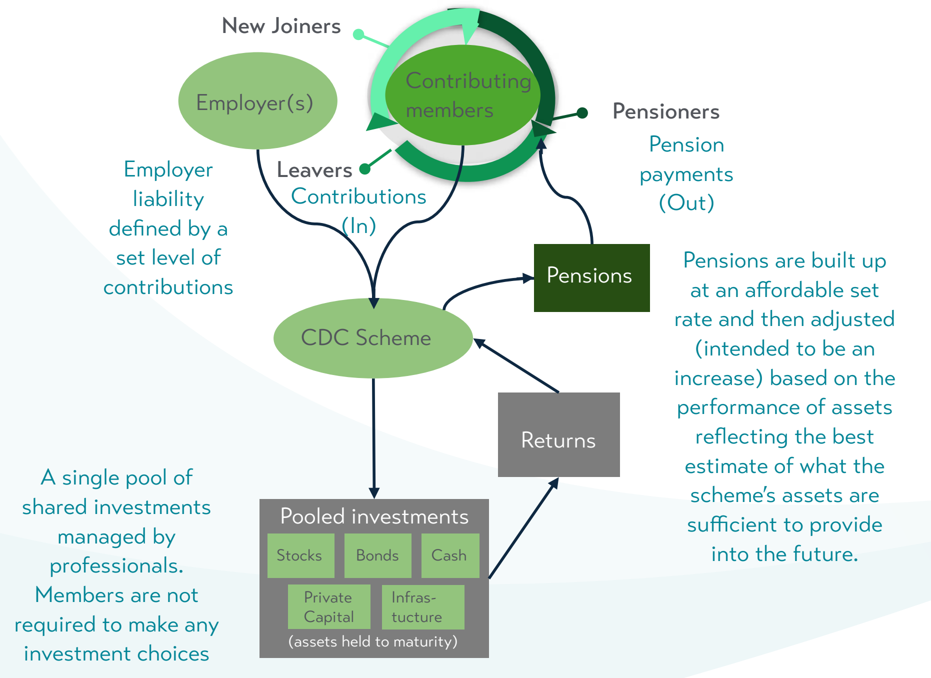
CDC schemes can be 'whole of life' or 'decumulation only'. A whole of life scheme operates over the course of an individual's pension savings journey, e.g. over both accumulation and decumulation. This provides a longer time horizon for investment opportunities and as a result potentially more predictable benefits. In a decumulation only scheme, the time horizon is shorter and as a result a more prudent investment strategy may be required to match to the risk profile of its members.

Current use

Risk pooled schemes with similar characteristics have been used in a number of other countries (e.g. the Netherlands and Canada). In the UK, the Pensions Scheme Act 2021 provided the legislative framework for CDCs.

There is only one authorised CDC scheme in the UK which is for a single employer - The Royal Mail Collective Pension Plan. The legislation does not currently permit multi-employer CDC schemes or decumulation only schemes, for CDC to be applicable to the wider retail market legislation will need to be passed.

The last Government stated an intention to amend the legislation to permit multi-employer schemes in 2024 and to allow 'decumulation only' schemes in the future. No further legislation has been announced to date.



Risk pooling and Collective Defined Contribution (CDC)

Options

Risk pooling as a solution

Risk pooling has certain features which have the potential for it to be an attractive solution:

- Risk is managed through a diversified portfolio and pools risk across different generations of members. This could enable members to benefit from greater certainty and outcomes when compared to individual DC.
- The potential for longer term, higher returns through investment in high growth illiquid assets.
- A longer-term investment horizon and a constant influx of leavers and joiners can provide additional flexibility to manage liquidity compared to DC provision where there is a need to ensure there is sufficient liquidity to deal with transfers out of individual members or a bulk transfer as a result of an employer choosing another provider.

For risk pooling to be progressed as an potential solution, there could be a need for:

- Greater awareness amongst providers and employers of what a pooled scheme is, how it works and the benefits in comparison to a DC scheme.
- Legislation to enable multi-employer CDCs in the UK, in addition, large employers and providers will need to invest in design of a CDC offering; regulatory authorisation; and launching the scheme in the market.
- Schemes to achieve scale in terms of number of members and assets under management (risk pooling is not generally suitable for smaller schemes or employers). The larger Master Trusts that already have scale and developed infrastructure could be well placed to have a pooled offering.
- A mechanism so that members can remain in the scheme but have contributions from successive employers to avoid transfers out (and disinvestment) when moving between employers.
- Value for Money to be operational and effective so that members can compare the benefits of different pension models and providers and switch between different providers as they want.

Observations

From discussions amongst the Expert Panel and Technical Expert Group there was consensus that as an option for exploration over the longer term multi-employer CDC has potential. However it was noted that the time required for CDC to have an impact could take a number of years, but that this might be accelerated if transfers in were allowed. It was also noted that CDC might suit employers and schemes that have particular characteristics, such as local government or quasi public sector organisations that have a large number of employees and longevity. Discussions noted that some of the characteristics of risk pooling and greater exposure to illiquid assets could be replicated within the existing DC industry framework once the participants have greater scale, thus mitigating some of the driving factors behind a need for schemes like CDC.

Risk pooling and Collective Defined Contribution (CDC)

Key considerations for CDC are:

- Ease of implementation - multi-employer CDC requires enabling legislation. Once legislation is in place it is likely to take 1-2 years for a scheme to be set up and become authorised with TPR.
- Time - taking into account the implementation factors above it is possible that it could take 10 yrs+ for the introduction of CDC to have a meaningful impact on DC investment in private capital.
- Impact - CDC has the potential for a material impact if the existing DC both in terms of potential to invest in illiquids, but also as a result of longer investment horizons.
- Suitability - the public sector may have the right characteristics to make advances in the use of risk pooling schemes.

Recommendation

The Expert Panel recommends:

Industry and Government should work together to consider how risk can be better pooled in DC structures in the interests of savers. In particular, CDC schemes should continue to be explored.

Overseas models

Features	Australia	United States	Netherlands
Description	Compulsory superannuation for all employees was introduced in 1992. Contributions can made into different types of superannuation funds ('super'), such as industry-focussed or retail funds, with some of the larger funds holding assets of above $200bn. 17 Australian superannuation funds own the asset manager, IFM.	Employees in private companies can choose to participate in a 401(k) plan which is monitored by the IRS3. The employees can choose from a variety of investment options, typically mutual funds.	A new pension system to be brought in by January 2028 will be a transition from DB and DC. The drivers of this are to move from system geared towards equal accrual to a system based on allocating an equal contribution. This is to tackle issues of fairness and remove complexity. The new system will be comprised of mainly two DC-like contracts: a solidarity pension plan (collective accrual phase where investment risks are shared) and a flexible pension plan (individual choices and the possibility for a collective decumulation phase). DB plans will no longer be permitted. Both of these plans have qualities of Collective DC (CDC) There is a third option, that effectively allows for the purchase of annuities from insurers.
Fund providers	There are 134 pension fund providers, with assets totalling AUS$3.5trn (£1.84trn) (c.60% of assets are in the 20 largest providers). The average super has 400k+ accounts and average balance of $117k (£61k)1. The performance of the funds is measured on a returns net of costs basis. Many large funds aim to keep fund costs below 50 bps.	There are more than 710k providers of 401(k) plans with assets of $7.4trn (£5.82trn) The plan can only be offered through an employer.	The Dutch DB pension funds have roughly €3.3trn. (£2.77trn) of total assets, across 100-150 providers, although there is a concentration of assets in a top tier of providers. Most DB schemes are expected to migrate to the new Solidarity pension plan. There are a few DC schemes and these are expected to mainly migrate to the flexible pension plan.
Contribution rates	Currently, the compulsory employer contribution rate2 is 11.5%, which will increase to 12% by 2025. This can be supplemented by employee contributions.	Employer contributions are not compulsory and in many circumstances, employers have a choice whether to match employee contributions. The average contribution rate was 14.2% in 2024 (note this is employer and employee combined).	The new system will have a flat-rate of contributions regardless of age which are subject to a tax ceiling of 30% of pensionable salary. The current contribution rates are c.24% of gross income of which roughly 70% is covered by the employers and 30% by the employees.
Private capital	Investment in private capital by the Australian super funds is approximately 5 - 6%.	In 2020, the US Department of Labour issued an information letter clarifying the conditions under which the private equity investments could be included in 401(k) plans which helped addressed previous views on risk, fees and liquidity. Currently the default funds within the 401(k) plans are a blend of equities and fixed income, with exposure shifting with age.	Existing large DB pension funds have private capital investments. The total amount contributed to private equity represented - 6% of total assets (applying 5% to £2.77bn equates to c.£140bn. Under the new system, there will be preset rules around the split of investments.

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Broader pensions context

Introduction

The focus of this project has been DC default pensions, and it is clear that the significant differences in the structure, regulation, and context of DB pensions and in particular, the Local Government Pension Scheme (LGPS), make both comparisons and generalisations difficult.

Nevertheless, the Expert Panel recognized the important role that DB and LGPS pensions in this discussion, in terms of the ability of the Government to set more specific requirements for public sector schemes, but also because of the importance of protecting those schemes' ability to continue to invest in long term private capital opportunities in a continuously evolving landscape. In the UK, DB pensions hold a market value of £1,400.8 billion, and the LGPS (England and Wales) holds assets of £354 billion.

Market context: Defined Benefit (DB)

DB Funding

The long-awaited funding code regulations were finally laid in Parliament in July 2024, having been delayed by the unexpected General Election. This means that the new code will apply to valuations after September 2024.

Throughout the development of the code there have been concerns raised by industry that it might impose an over restrictive to DB schemes in their investment decisions in order to encourage de-risking, and there were particular concerns raised by open DB schemes about the impact.

There is initial consensus that the final draft code has taken a more balance approach, which is positive for DB's ability to invest over the long term. Regulators should ensure that this approach continues in implementation.

Consolidator role for the Pension Protection Fund

In 2023 the DWP issued a Call for Evidence seeking views on the use of assets held by DB schemes, including the potential for the Pension Protection Fund to play a consolidator role, to better enable investment in 'productive' finance.

A range of options for maturing schemes

As an increasing number of schemes move towards maturity, there remains a number of different options for trustees to consider. For example, many schemes make use of buy-out opportunities through insurers, and the Government has continued to consider the role of DB superfunds as a consolidator, with regulations expected in the forthcoming Pensions Bill. However, only one superfund currently exists. Favourable funding conditions in recent years has resulted in a debate on what should happen to scheme surpluses, and there remains interest in the future of the employer covenant link.

There are a range of views on these complex matters, but it's clear that future Government and regulatory policy decisions, and decisions made by trustees on how to best use the assets of DB schemes, could have a significant impact on where they are eventually invested.

Growing awareness of climate risk

In recent years, regulatory and saver awareness of climate risk has grown, and the majority of pension schemes are now mandated to report on the level of risk associated with their scheme's investments. In addition to this, many schemes have now made commitments to net zero alignment targets - figures from the PLSA suggest 68% of schemes now have such a commitment in place.

Though it's clear that climate risk is a consideration in all investments, the ability of schemes to invest in emerging technologies and infrastructure is likely to require a diverse range of investment options, including in private markets.

Broader pensions context

Market context: the UK's Local Government Pension Scheme

Further pooling

Since 2015, 8 LGPS pools have been established in England and Wales, enabling LGPS funds to transfer assets, and benefit from enhanced scale, improved expertise, capacity, and reduced costs. This has had an impact on many parts of the scheme in terms of savings and investment scale though, with only around 39% of assets transferred in total, perhaps not on the scale originally intended.

In 2023 the then Government consulted on implementing a deadline for all listed England & Wales LGPS assets to be transferred to a pool by 2025. The consultation also noted that funds may wish to review unlisted assets for suitability to be transferred. The new Labour Government has since confirmed that it plans to consider the case for further pooling, with the aim of unlocking further investment and reducing fees, as part of the Pensions Review. Consolidation of assets is beneficial in terms of ability to achieve scale and the ability to make larger investments, and it's clear that the LGPS has a strong track record in private capital investing.

However, anecdotal evidence suggests that the process may have restricted how far the LGPS can invest in their own local areas, either to meet Government targets, or to meet their own 'Social' aspirations. Given the long history the LGPS has in investing in regions, and its institutional knowledge of private capital, the Government should ensure that any reforms do not inadvertently result in these connections and knowledge becoming redundant.

Government role in LGPS investment decisions

In 2022, the previous Government announced a plan to ask LGPS funds to invest in local assets, as part of its 'Levelling up' agenda. Though the target is not enforced as mandatory, funds would be required to set out a plan. A further consultation in 2023 explored a non binding target for private equity investments.

The new Labour Government has announced that the LGPS will be under consideration in Phase 1 of its Pensions Review, with the Terms of Reference stating it would look at "Tackling fragmentation and inefficiency in the Local Government Pension Scheme through consolidation and improved governance".

For Local Pensions boards, it remains unclear what this will mean in practice, but it would seem that Local Pensions Boards should expect that central Government will be more involved in investment decisions moving forward, than has historically been the case.

Summary of considerations

The particular issues affecting DB and LGPS schemes are not within the remit of the Pensions and Private Capital Expert Panel or Technical Expert Group, and so no specific recommendations were discussed in relation to them.

However, the Expert Panel acknowledged the important role that non-DC pensions play in setting an example and believe that it is important that the regulatory landscape continues to enable all pensions to be able to make long term private capital investments. It was also noted that public sector schemes are an area the Government can have the most influence.

The Government can help DB and LGPS invest by:

- Providing a stable and consistent regulatory environment.
- Ensuring that schemes, particularly the LGPS, are able to continue to invest in local initiatives, including where consolidation has occurred.
- Ensuring the DB funding rules do not restrict DB schemes' ability to invest in private capital. This is particularly important for open DB schemes.

Next steps

The BVCA will continue to engage with the Government and stakeholders to ensure that access to private capital investments are considered in the evolving DB and LGPS landscape.

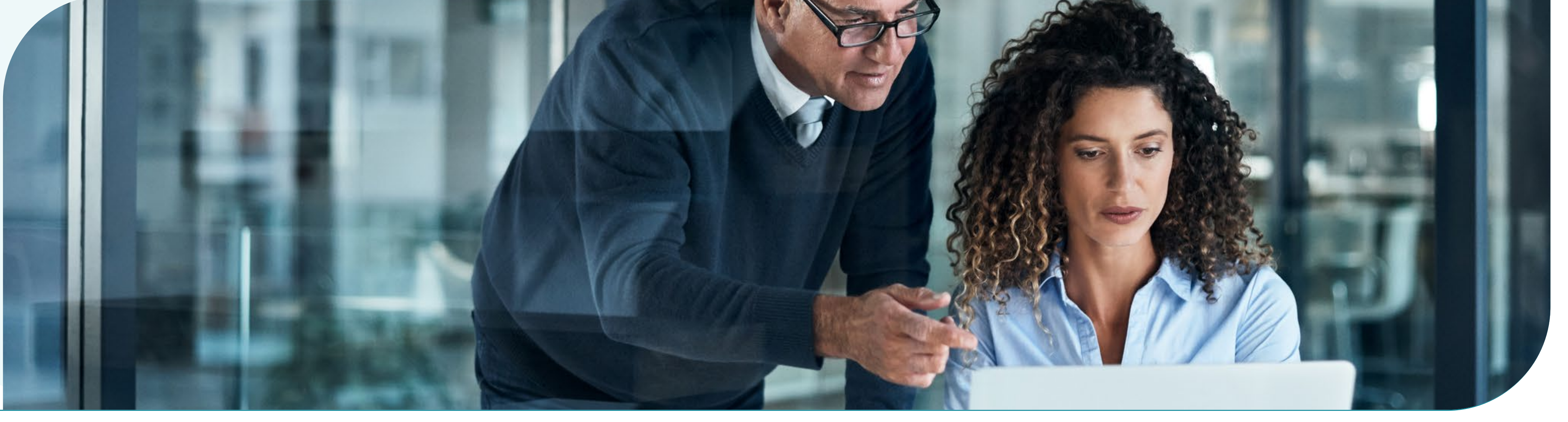
Next steps for the Expert Panel

Focus for the Expert Panel towards Spring 2025

The recommendations set out in this report aim to provide policymakers with a clear roadmap to facilitate meaningful change, and a pathway to supporting DC schemes in achieving their commitments set out in the Mansion House Compact. Establishing a mutual understanding across both the pension and private capital industries, alongside an outline of the effective role that policymakers can have to achieve a stronger, more effective partnership, has been the focus of the Expert Panel since it first convened in February 2024.

Through the Expert Panel, the private capital and pensions industries remain committed to the strong partnership to help improve outcomes for pension savers and support UK economic growth. The Expert Panel will continue to progress its programme of work into early 2025 when it will publish a final report. Since the launch of the Expert Panel, the wider context in which this work has been developed has changed. Following the General Election in July 2024, there is a new Government with a strong commitment to deliver the dual policy objective of increasing retirement outcomes for pension savers, while delivering UK economic growth. The UK Government set out several areas of focus, including the launch of a Pensions Review with the terms of reference for the first phase of this set out in August 2024, shortly followed by the Government's launch of a call for evidence on the Pension Investment Review.

As demonstrated by the ABI Mansion House Progress Update, the Government's agenda is complemented by the ongoing ambition by both the pension and private capital industries to facilitate change. The Expert Panel, as an industry-led initiative, will continue to build on the areas set out in this interim report, in light of the wider political development and will assess how the Expert Panel can best contribute to the Government's programme as a collective. The representatives that form the Expert Panel, in particular the trade associations formed of ABI, BVCA and PLSA, will also work on behalf of their respective members to contribute to this process.



Next steps for the Expert Panel

Continue to build mutual understanding between the pension and private capital industries.

The Expert Panel, supported by the Technical Expert Group, will work collectively to continue building mutual understanding of the key features of both industries. This will focus in particular on the development of the Value for Money (VfM) framework. Work will continue on demonstrating the investment case for investing into private capital funds. The BVCA will work with the TEG to develop a specialised training module for TPR. This will continue to develop understanding amongst the pensions industry of the key features of the pension industry. The Expert Panel will also work with industry to explore the feasibility of developing a model Request for Proposal, and guidance to facilitate greater clarity on costs.

Ensuring the right regulatory landscape

The Expert Panel will continue to engage with the FCA on the regulatory challenges in the existing market infrastructure set out in the interim report, particularly in relation to the permitted links rule and rules around the wider distribution of LTAFs. The Expert Panel will also explore areas where further awareness would be beneficial, including the hybrid platform and custodian model. This work will continue to discuss the proposals on Permitted Links rules and a review of LTAF, and liquidity guidance, with the FCA and other regulators over the coming months.

Contribute to the ongoing Government agenda to deliver meaningful change.

The Expert Panel will continue to assess how it can best contribute to the Government's Pension Review and upcoming Pensions Bill, to ensure that the UK pension system can reform and evolve to benefit UK pension savers and increase investment into UK businesses. As set out in this interim report, the Expert Panel has outlined several key areas for the Government to consider, in particular in relation to the development of a new investment vehicle or scheme and features of overseas pension systems. The Expert Panel will continue to provide a valuable source of expertise on these issues.

Appendix 1

Pensions & Private Capital Technical Expert Group

ABI
Adams Street
Albion
Apposite Capital
Ardian
Aviva
BESTrustees
BGF
Bridges Fund Management
British Business Bank
BVCA
Capital Cranfield
CMS
Dalriada Trustees
EY
Federated Hermes
Fried Frank
Fulcrum
Hamilton Lane
Herbert Smith Freehills
Hymans Robertson
ICG
Insight Investments
Investment Association
LCP
Linklaters
Macfarlanes
Mercer
Mobius Life
Molten Ventures
Pantheon
Phoenix Group
PLSA
PwC
Redington
Schroders
Simmons & Simmons
Slaughter and May
Travers Smith
Vidett
Vitruvian Partners
WTW

Appendix 2

Private capital explained

Private capital explained: asset-class distinctions

The value proposition of private capital firms is generally based on successfully identifying promising unlisted companies, acquiring either minority or controlling stakes, spending several years increasing their value, and then selling them at a profit for investors. Within this broad approach, there are different investment strategies aimed at different stages of companies' growth, with different considerations for investors.

Sources of capital

Private capital funds pool money from investors around the world to execute their particular investment strategy. Investors ranges from overseas pension funds, sovereign wealth funds or insurance companies, to local authority pension schemes, charitable foundations, family offices, high net worth individuals, or university endowments. In 2022, the Private Capital industry invested £27.5bn in 1,600 UK companies, of which 9 in 10 were small or medium-sized businesses. businesses directly generated 6% of total UK GDP.

Venture capital

Venture capital funds typically invest minority stakes in innovative companies with very high growth potential in their early stages of development. Venture firms pursue an active ownership model focused on high growth potential. They provide expertise and capital proportionate to the risk/return appetite and needs of the business for the stage it has reached, from developing products and services at the earliest stages, to becoming established businesses which can then be scaled. Venture capital funds can hold their investments for long periods, over 10 years in some instances. Venture capital can be divided into the following stages of investment as the companies grow from startups to mature companies:

Seed capital: the earliest investment stage for companies with the aim to support founders and entrepreneurs turn ideas into viable businesses. Seed funding can help companies with market research, product development, and hiring a founding team. Funding typically comes from angel investors and early-stage VCs.

Series A: the first substantial round of investment provided by venture capital funds. Companies that receive this funding have developed a product or service that has found product market fit and often demonstrating strong revenue growth. The destination of the capital would be mostly to cover capital expenditures, drive growth, and build out the founding teams.

Late-stage venture: investment received by companies in the later stages of development, usually funding in series B, C & D rounds. This can often include companies close to acquisition or IPO. At this stage, the company has usually shown significant market traction and is ready for substantial growth.This overlaps with growth equity but remains minority rather than controlling stakes.

The above is illustrative and reflective of startups that have a quick route to market (e.g. software companies). Startups in Research & Development intensive/Intellectual Property rich sectors such as deeptech and life sciences typically require greater investment at the early stages and take longer to develop products.

Private capital explained: asset-class distinctions

Growth equity

Growth equity firms provide additional capital, building from the late-stage venture, to enable companies to continue their growth as they increase in scale. This capital is critical to continue a company's innovation and job creation. Growth equity firms also provide expertise to manage a company, risk and grow a company successfully.

Growth equity firms manage funds that typically make private equity investments (including some minority investments) in relatively mature companies that might be looking for primary capital to expand and improve operations or enter new markets to accelerate the growth of the business. Growth equity deals involve taking control of the business where the management team implements a plan to drive growth and make operational improvements. Hold periods are typically 4-6 years.

Global buyout

Global buyout firms manage funds that typically take controlling stakes in larger, more established private companies, or acquire businesses from the public markets through a buyout transaction. In the same way as growth equity, an investment by a Global Buyout fund provides a company with access to capital and strategic and operational expertise to boost its growth and profitability.

Private capital explained: performance metrics

Private capital fund performance evolves during the life of a fund and a range of metrics are used to give a full picture during a fund's life

Assessing private capital fund performance goes beyond measuring IRR

There is a common misconception that the private capital industry relies solely or primarily on the Internal Rate of Return (IRR) to calculate fund returns. In reality, there are several key metrics for calculating fund performance and returns in the private capital industry. Investors will find that different combinations of them work best for them in assessing their private capital portfolios in different ways.

Institutional investors typically agree information rights focused on these metrics, including detailed reporting requirements on performance and fees when they make an investment into a fund.

Metric	Description	Uses and considerations
IRR (internal rate of return)	IRR.is the annualised discount rate that makes the net present value of all cash flows equal to zero.	The calculation accounts not only for the magnitude of the returns but also their timing. This means that returns (both positive and negative) in a short period of time have a larger impact on IRR than those over a longer period.
TVPI (total value to paid in capital)	The total amount distributed plus the residual value attributable to investors as a percentage of paid-in capital. This reflects the value of the investment (both what has been returned and what is still being held) compared to the amount contributed.	Takes into account the value of unrealised investments so is useful for measuring ongoing performance before all investments have been realised. Does not capture the timing of investments and realisations.
DPI (distributed to paid in capital)	The amount distributed to investors as a percentage of paid-in/committed capital the total. This ratio shows how much money has been returned to the investor compared to the amount they have contributed.	This 'cash-on-cash' measure is a popular way to assess performance, particularly for mid-life funds. At the end of a fund's life, the TVPI and DPI will be the same as all assets will have been realized and distributed.

Appendix 2

Characteristics of Life Platforms, Custodians and Hybrids

Characteristics of Life Platforms, Custodians and Hybrids

The three structures each have different characteristics particularly in relation to the rules on investing in private capital. The custodian and hybrid approaches in particular have certain, potentially less well-known features that may facilitate investment in private capital for some DC providers.

Feature	Life Platform	Custodian	Hybrid
Cost	The ongoing cost and complexity of operating a life platform and custodian is broadly comparable (particularly at scale, for smaller providers the use of a custodian may be more expensive), and this is also broadly true where a hybrid brings together functions from both. The specifics of price will be determined by a number of factors including the commercial arrangement.		
Asset ownership and segregation of assets	The insurer has an obligation to the member to meet the contractual terms of the insurance policy, however, this means that the insurer (subject to certain rules) does not need to hold the specific assets that the member has invested in, it just needs to hold sufficient assets of various types to meet the obligations of the policy. This also means that it does not need to segregate the contributions from the member, it can commingle those funds with those of other members. This provides the insurer with flexibility to invest the assets and reduce costs.	Assets are held on behalf of the trustee who is the legal owner. The custodian applies illiquid a notional unitisation to share out the assets by member.	Able to provide the features of both a life platform and a custodian.
Regulator	FCA and PRA (and subject to Permitted Links rules)	FCA and TPR	FCA, PRA and TPR apply to the extent assets are held on or off a life Platform.
Financial Services Compensation Scheme protection (FSCS)	'Contracts of long-term insurance' provided by UK-regulated insurers qualify for protection of 100% with no upper cap from the FSCS. The protection provided by the FSCS is untested as there has not been a failure of a major insurer during the period it has been in place. As assets in DC increase rapidly the ability of the FSCS to provide 100% protection may be amended if it is considered to be unable to be supported.	No FSCS protection	FSCS protection applies to the extent assets are held on or off a Life Platform model.
Service provision	Life insurance platforms usually offer a bundled solution providing a range of services under one umbrella, this makes implementation practical and cost effective.	Master Trusts that don't use life platforms have a greater tendency to use separate administration and investment providers in the absence of a bundled service.	Similar to those providers that use a custodian model, outside of life platforms that usually offer a bundled solution there is a choice of options.
Providers	Both insurers and custodians are typically well established brands in the financial services markets that have large economies of scale.		New to market - to date one provider, Mobius Life.
Other considerations	Insurance companies in the UK are subject to strict capital requirements to prevent a scenario arising in which an insurer is unable to meet its commitments (Solvency II). Solvency II dictates the level and quality of capital that an insurer must hold which are subject to stress tests. Life insurance platforms benefit from a number of tax exemptions.	Not subject to Solvency II	Solvency II applies to the extent assets are held on a life platform model.

Glossary

Glossary

AIFMD: Alternative Investment Fund Managers Directive. An EU regulation that covers governance and independent asset valuation for professional investors.

ATO: Australian Tax Office. The principal revenue collection agency for the Australian government.

AUM: Assets Under Management, the total market value of the investments that a person or entity manages on behalf of clients.

Carry/Carried Interest: A share of the returns of a fund that is received by the private capital firm managing the fund once investor capital has been paid back and any preferred return threshold has been met.

Catch Up: A provision in a fund agreement that allows the private capital firm to receive its share of profits after the preferred return hurdle is met.

Closed-ended Funds: Investment funds with a fixed number of shares, which can often be traded, but that do not allow investors to redeem their interests and typically have a fixed size and duration.

Commingled Funds: Investment funds that pool assets from multiple investors, allowing for shared costs and diversified investments.

DC Charge Cap: The regulatory limit on the total amount of fixed charges that can be imposed on members' defined contribution pension pots.

Default Fund: The investment fund chosen for a pension plan's contributions if no alternative is selected by the member.

Defined Benefit (DB): A pension plan where benefits are predetermined, based on salary and length of service, and not directly linked to investment performance.

Defined Contribution (DC): Pension schemes where the benefits are based on the contributions made and the investment returns those contributions have earned.

DPI: Distributed to Paid-In Capital. A ratio that shows how much money has been returned to the investor compared to the amount they have contributed. It is a measure used to assess fund performance.

DWP: Department for Work and Pensions. The UK government department responsible for welfare and pension policy.

ESG Reporting: The disclosure of environmental, social, and governance factors that impact, or are impacted by, a company's operations and performance.

Exit: The process of selling or disposing of an investment.

FCA: Financial Conduct Authority. A financial regulatory body in the UK.

Fund Waterfall: The contractual payout sequence of proceeds generated by a fund between investors and the private capital firm.

Global Buyout: Funds that typically take controlling stakes in larger, more established private companies, or acquire businesses from the public markets, through a buyout transaction.

Growth Equity: Funds that typically make private equity investments (including some minority investments) in relatively mature companies that might be looking for primary capital to expand and improve operations or enter new markets to accelerate the growth of the business (see Appendix 1 for more detail).

IPEV: International Private Equity Valuation guidelines. Guidelines that provide a methodology for private capital valuations, which is widely adopted and overlays global accounting standards. IPEV is overseen by an independent board.

IPO: Initial Public Offering, the process of offering shares of a private corporation to the public in a new stock issuance.

IRR: Internal Rate of Return, one of the metrics typically used to estimate the profitability of potential investments.

IRR: Internal Rate of Return. A metric used to calculate fund returns in the private capital industry.

J-Curve: The pattern of initial negative returns followed by a period of positive returns typically experienced by private capital funds due to their staggered investment cycle.

Glossary

LGPS: Local Government Pension Scheme. Public pension schemes for local government employees in the UK.

Life Platforms: Integrated investment solution that offers a range of financial products and services. These are typically used by insurance, pensions, and asset management industries for buying, selling and holding a range of different investments.

Lifestyling: an investment strategy adopted in preparation for retirement which considers and protects savings from risk.

LTAF: Long-Term Asset Fund, an FCA authorised fund classification, designed for DC and certain retail investors to invest in assets that are typically less liquid than listed stocks or bonds.

Master Trusts: A DC pension scheme with multiple, unconnected employers, managed by a single trust with a shared governance structure.

NAV: Net Asset Value, used as a substitute for market prices in private capital to calculate typical public market measures like periodic returns.

OCF: Ongoing Charges Figure, the DC measure of the annual cost of investing in a fund, including fees and operational expenses.

Open-ended Funds: Investment funds that allow investors to redeem their interests and typically can issue new interests on an ongoing basis.

Permitted Links Rules: Regulatory rules that govern the types of asset that can be invested in via life platforms.

Preferred Return: A minimum threshold return that limited partners are entitled to receive before the private capital firm can participate in profits.

Private Capital: The collective term for the private equity and venture capital industry which provide investment for businesses at different stages of a company's life cycle – ranging from the early stage to mature companies – dependent on the investment strategy of the fund (see "Private Capital explained for more detail").

RfP: Request for Proposal, a document soliciting bids from potential vendors for a project.
Secondary Markets: Markets, organised or otherwise, where investors buy and sell interests that already exist, rather than buying new interests directly from the issuing companies or funds.

TEG: Technical Expert Group. A group that provides technical expertise on specific topics.

TVPI: Total Value to Paid-In Capital. A performance metric that reflects the value of the investment compared to the amount contributed. It includes the total amount distributed plus the residual value attributable to paid-in capital.

Value Proposition: The unique value a product or service provides to customers, distinguishing it from competitors.

Venture Capital: Funds that typically invest minority stakes in innovative companies with very high growth potential in their early stages of development (see Appendix 1 for more detail).

bvca

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