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Invested in a better future

Laura Trott, MBE, MP
Minister for Pensions
Department for Work and Pensions

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Dear Minister

Re: Options for Defined Benefit schemes: a call for evidence

The BVCA is the industry body and public policy advocate for the private equity and venture capital (private capital) industry in the UK. With a membership of around 650 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and a large base of UK and global investors. We are happy for the content of this submission to be quoted in any future response the Government may issue.

Why the BVCA agrees with the direction of Government policy in this area

We welcome the Government's agenda of improving opportunities for UK pension scheme investment in productive finance, including private capital funds, and improving UK pension savers' retirement outcomes. The direction of Government policy here is supported by robust BVCA returns data which clearly demonstrate that the UK's private capital fund industry has a four-decade track record of delivering market-beating returns and diversification benefits for global institutional investors. Investment activity data provided by BVCA members also clearly demonstrate that UK DB schemes comprise only a very small part of the UK private capital fund industry's pension investor base, which is dominated by overseas DB (and DC) schemes (alongside a range of other types of institutional investor).

We therefore applaud the DWP's objectives of encouraging consolidation amongst UK's pension schemes, where necessary, and facilitating their access to long-term, high-performing illiquid assets. The Mansion House proposals are an opportunity for the Government to improve retirement prospects for millions of UK pension savers by starting to level the playing field between UK schemes and other institutional investors. Non-UK pension schemes, for example, can already improve the outcomes they achieve for their beneficiaries by building balanced, resilient portfolios with a broad range of assets, including illiquid strategies. Currently members of overseas pension schemes are benefitting from investment in UK growth companies via UK private capital funds, which offer different risk-return profiles and collectively have consistently outperformed public equities, in far greater numbers than members of UK pension schemes.

In addition, the UK private capital fund industry is a critical partner for Government in driving economic growth and ensuring that the UK's high-growth businesses of tomorrow can access the capital they need to start up and scale up in the UK. In 2022, £27.5bn was invested by private capital funds into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital, which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside London and 90% of the businesses receiving investment are small and medium-sized businesses. The UK pensions industry urgently needs improved access to these innovative, unlisted UK companies that private capital funds identify and then support to realise their growth potential. The private capital fund industry's investment of capital and expertise in that collective potential is a powerful driver of broader economic growth across the UK.

We have responded below to the questions in the call for evidence on which our members have specific views.

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Q1: There is some evidence that DB schemes are underinvested in productive assets compared to international comparators. Do you agree with the assessment of the position? Is there evidence to the contrary?

Evidence that UK DB schemes are underinvested in private capital funds, relative to international pension funds:

We agree with the Government's assessment that UK DB schemes are underinvested in private capital funds, compared to international comparators.

The benefits of investing in UK private capital funds are already acknowledged by pension schemes around the world. The successes of, for example, Canadian and US schemes investing in alternative asset classes is well known. Yet, despite the UK having second largest pensions market in the world, UK pension schemes invest much less in private capital funds than their global peers. Data from the BVCA's latest Report on Investment Activity shows that although 30% of all capital raised by UK PE/VC funds in 2022 came from pension schemes, often based in North America, only around 4% of that investment came from UK pension schemes.

Across private UK DB schemes as a whole, research by New Financial commissioned by the Capital Markets Industry Taskforce suggests that allocations to private capital are merely 1%. Independent commercial data from Preqin confirm that allocations to private capital funds by non-UK pension funds are typically much higher, with the Canadian pension schemes most active in private capital investment typically allocating on average 21% of their capital to private equity and the top US schemes averaging 14%, whilst even the UK private DB schemes most active in private capital on average allocate only about 5%.

UK DB schemes as a whole continue to appear under-allocated to private capital when we use the narrower international comparison of jurisdictions where the DC/DC split in the domestic pensions market is similar to that of the UK in terms of the dominance of DB schemes. Recent research by the Thinking Ahead Institute suggests that the percentage allocation to alternative assets (which includes private capital funds) of the overwhelmingly DB-focussed pension markets of the Netherlands (20%) and Japan (14%) significantly outstrip that of the UK (9%). Alternatives allocations in those markets are also growing year-on-year, whilst in the UK they are declining.

Overall, we feel the evidence is very clear that UK pension savers, across DB and DC, have been missing out on the market-beating returns and diversification benefits that private capital funds have historically offered.

Evidence that institutions investing in UK private capital funds have consistently received market-beating returns:

A key reason often cited to explain why non-UK pension schemes have invested significant amounts into UK private capital funds is the industry's track record of delivering market-beating returns. The BVCA has been collecting UK private capital fund returns data from members and publishing aggregated UK industry-wide performance reports using a data set stretching back to the 1980s. These offer the most comprehensive and robust record available of UK private capital fund returns. Below we have set out how this dataset demonstrates that private capital funds have collectively and consistently delivered market-beating returns.

The BVCA's upcoming[1] Public Market Equivalent (PME) report applies two rigorous methodologies to present a comparison of the relative performance of private capital funds managed by BVCA members against the public equity market, as represented by the FTSE All-Share Total Return index and by the MSCI Europe Total Return index. The key conclusions from the upcoming PME report to be published next week include the following:

1. Collectively, private capital funds managed by BVCA members have outperformed the stock market as represented by the FTSE All-Share and the MSCI Europe, the most comparable indices for the range of small,

[1] We will be happy to provide this once published. Last year's edition based on the previous year's returns data is available here.

medium and large investments held by UK private capital funds, in each year since 2001.

2. Since 2001, investors would have earned 34% more from investing in funds managed by our members than if they made equivalent investments in the FTSE All-Share Total Return Index.

3. Since 2001, investors would have earned 41% more from investing in funds managed by our members than if they made equivalent investments in the MSCI Europe Gross Total Return Index.

The BVCA's 2022 annual Performance Measurement Survey then uses a large dataset of member fund level cash flows and valuations from 1980 to 2022 to provide significant, up-to-date detail on the returns achieved for investors in private capital funds. The findings clearly indicate that:

1. Private capital funds managed by our members have collectively continued to outperform the FTSE All Share for investors over three, five and ten year time horizons.

2. Since 2001, investors into private equity and venture capital funds have collectively earned a pooled return of 14.3% per annum. These annual returns are equivalent to investors nearly doubling their money, getting a 1.81x pooled return on capital invested, including the value of unrealised investments as at 31 December 2022.

3. Large private equity funds performed the best out of all fund subcategories, delivering a pooled return of 15.6% per annum since 2001.

4. Private capital funds perform particularly well for investors in the medium and long term, with returns being reasonably resilient throughout the economic cycle (hinting at the diversification benefits of this asset class).

The economic case for Government policy to support investment by UK pension schemes into private capital funds, in terms of overall returns and diversification, was also highlighted by the Productive Finance Working Group, whose 2021 report cited "a wide range of literature [that] illustrates how less liquid assets can outperform their more liquid, often listed, counterparts." The PFWG report cited the conclusions of earlier research conducted by various academics and data providers, and supports the BVCA's own analysis of member data which suggest that the UK's private capital fund industry as a whole has consistently delivered higher returns to investors than the FTSE All Share Total Return index, from at least 2001 onwards.

The BVCA's data (cited in the PFWG report) relate specifically to the historic returns delivered by typical, comingled, closed-ended private capital funds. They do not relate to other less mainstream or more bespoke arrangements like co-investments that fund managers may agree with particular investors. We do not collect data on returns from such arrangements and cannot confirm whether or not they have historically delivered returns comparable to those delivered by our members' private capital funds. Our point here is that those arrangements are a different type of investment to an investment in a private capital fund, with different risk/return profiles likely in each case. That said, we have observed an increase in the popularity of co-investments amongst sophisticated institutional investors over the past decade. The ongoing attraction of capital to such arrangements makes us inclined to believe that many investors have witnessed those arrangements generating attractive rates of return.

To complement BVCA and PFWG data, there is also US research that shows how allocations to private assets can improve investment performance:

1. Data from US endowments and foundations provided to Cambridge Associates LLC showed that portfolios with more than 15% allocated to private investments have outperformed their peers consistently, and for decades. Cambridge attributed the outperformance to venture capital, private equity, and distressed securities far outperforming public asset classes, earning annualized returns of 12.5%, 11.9%, and 10.8%

respectively over the 10 years covered by the report.

2. Analysis by Willis Towers Watson looked at the asset allocations of a subset of large plan sponsors for 2010 and 2011, comparing DB and DC plan performance to simulated investment returns. Using an asset-weighted measure of returns, DB plans outperformed DC plans by an annual average of 76 basis points from 1995 to 2011.

Q2: What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?

BVCA view of why private sector DB schemes allocations to private capital funds have declined:

There are multiple reasons why DB schemes have not previously invested in productive assets, including the legislation and guidance from TPR that schemes and trustees need to follow.

Private sector UK DB schemes are typically closed both to new members and to the future accrual of benefits. This is partly as a result of legislative and regulatory developments that have driven DB schemes to value pension liabilities by reference to gilt yields and then to invest their assets in gilts (and LDI) to ensure the asset volatility matches the liability volatility ("de-risking"). These changes increased the cost to the employers of providing DB scheme benefits, as it not only increased the price of the liabilities but also reduced the contribution of investment returns in funding the liabilities, requiring more from employer contributions. This has meant that risk is no longer shared and pension provision has largely shifted to the DC model where scheme members now bear all the risk. From the perspective of UK equities and private capital funds, it has required DB schemes to reduce or eliminate their allocations to such assets.

Remaining DB schemes' focus is now almost entirely on meeting their liabilities to pay the pensions of existing beneficiaries, and so they now mainly invest in low-risk, income-generating assets in a bid to avoid asset and liability divergence and match the maturity of their defined benefit liabilities (where the volatility of the value of liabilities is linked to gilt yields). This is a key reason why private UK DB schemes typically take a conservative investment approach and are usually less attracted by higher risk assets that target longer term capital growth (and above all are not matched to gilt yields), such as private equity and venture capital funds (nor indeed by listed equities). The guidance from The Pensions Regulator also effectively compels them to this approach.

A main factor in the legislation has been the prohibition on any requirement for consent from the employer in setting investment strategy. This was introduced in the Pensions Act 1995 and overrides the provisions of the DB schemes. It has the effect that the party primarily bearing the risk of underperformance from the DB scheme assets has no say in the investment strategy. It also means that factors arising from accounting rules have only a limited bearing on the asset allocation of DB schemes as trustees are not required to have regard to the impact on the employer's balance sheet (although they may).

The next factor in legislation was setting the exit debt on the employer (the "s.75 debt" under the Pensions Act 1995) at insurance market pricing. This was an anti-avoidance measure that has effectively become the ultimate funding target and the Pensions Regulator currently advises trustee to compare their ongoing funding basis (technical provisions) to this target.

The main driver, however, has been the Pensions Regulator's evolving guidance to trustees in respect of the Pensions Act 2004, including the Code of Practice on Scheme funding (no.3) and Annual Funding Statements, and more recently, the Pension Schemes Act 2021 and the related proposed draft Occupational Pension Schemes (Funding and Investment and Amendment) Regulations 2023, the draft Funding Code of Practice and the Pensions Regulator's guidance on long term funding targets ("LTFTs") in more recent Annual Funding Statements.

The guidance often goes beyond legislation or does not fully reflect the balance available in the legislation. For instance, current legislation on investment of DB scheme assets (derived from EU law) requires trustees, amongst other matters, to (a) ensure assets are properly diversified to avoid accumulations of risk and (b) ensure the security, quality, liquidity and profitability of the portfolio as a whole. The investment strategy section of the current Code of Practice on Scheme Funding, mentions liquidity but mentions diversification only in relation to the employer's sector. It does not mention profitability. It also refers to the purpose of scheme assets as providing collateral and security for the benefits, rather than a source of funding for those benefits.

The current Code and guidance from the Pensions Regulator more generally advises trustees to minimise risk in funding assumptions and investment strategy, particularly where such risks are not reliably underwritten by the employer's financial resources (the word "risk" appears 130 times in the current Code of Practice on Scheme Funding). All of the emphasis is on downside risks.

LTFTs are the latest development and the policy is being implemented in advance of the legislation. This is a funding basis based on low dependency on the employer, i.e. minimising the risk of future deficits emerging, or on insurance market pricing. This in practice requires trustees to value the liabilities using a discount rate based on the yield on gilts and to adopt an asset strategy that minimises the risk of divergence between the value of the liabilities and assets over time. The result is that trustees are required to buy gilts and LDI.

BVCA suggestions regarding policies that could be considered to increase DB allocations to private capital funds:

It may be difficult to reverse the consequences of several decades of policy on DB schemes. The schemes are now largely closed and in run-off even though some of the benefits may not fall due for many years. Even restoring the employers' right to have a say in the investment strategy which they underwrite or reemphasising the requirement for profitability and diversification in the portfolio may not reverse the trends, since employers themselves are now seeking closure.

As we understand that DB schemes hold nearly half of UK government debt not held by the Bank of England, we query whether there is sufficiently robust evidence that encouraging DB schemes to move away from gilts in a material way would not erode support for gilt prices and have a detrimental impact on Government borrowing and mortgage costs (and indeed on the DB schemes which have allocated c.50% of assets to government bonds, not to mention LDI). We have not engaged advice from economists on this, but would urge the Government to explore this proposition thoroughly before it becomes the basis for policy development.

However, some schemes are underfunded and both trustees and employers may want to see improved investment returns and diversification and a small shift in allocation could be significant both for the DB schemes and for private capital funds, without destabilising gilt prices.

We suggest that the Government consider the following policy steps, which we believe would collectively provide for greater flexibility and incentives for DB schemes to allocate capital to a broader range of assets, including UK-managed private capital funds:

- Stop increasing pressure on trustees to buy government bonds and "de-risk" by not implementing the draft Occupational Pension Schemes (Funding and Investment and Amendment) Regulations 2023 (the "Draft Funding and Investment Regulations") and related draft Funding Code of Practice.

- Remove the prohibition on employer consent requirements in relation to investment of DB scheme assets (and provide for employer consent in the provisions for accelerating the low dependency funding basis ahead of "significant maturity" in the Draft Funding and Investment Regulations if implemented).

- Provide a "safe harbour" for a percentage allocation to private capital funds for DB schemes that are not winding-up or intending to wind up in the near term.

- Implement legislation for DB consolidators and base conditions for transfers to DB consolidators on adequacy of funding for DB consolidators rather than likelihood of achieving insurance market funding over time.

Q10: What impact would higher levels of consolidation in the DB market have on scheme's asset allocations?

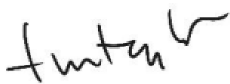
As the Government is aware, the UK's DB sector is fragmented, comprising more than 5,200 schemes with an average size in the hundreds of millions rather than billions. Generally, it is easier for larger investors to run effective private capital investment programs and diversify across managers, geographies and vintages, which is an important ingredient of effective investment strategies. So we would expect the consolidation of UK DB schemes into fewer, larger schemes to facilitate an increase in the aggregate deployment of DB scheme capital into UK private capital funds.

The World Bank's 2018 report on the Canadian pension system concluded that scale allows pension funds to access a broader range of assets, improve member outcomes and reduce costs. The World Bank also suggested that scale is important to make it economical for pension funds to invest in the level of in-house expertise required to select private capital fund managers, manage partner relationships and generally run a private markets program effectively. Where investors have sufficient scale to bring this work in-house, according again to the World Bank, their returns (net of additional costs) are likely to improve, relative to exclusive reliance on external advisers and consultants. Scale also allows investor portfolios to achieve an appropriate level of geographic, sector and asset class diversification, which also tends to result in stronger returns and diversification benefits. The World Bank's conclusions were supported somewhat by DWP's own analysis, in its 2018 white paper on Protecting Defined Benefit Pension Schemes, which concluded that consolidation would reduce UK pension schemes' running costs, improve their investment strategies (including by allowing a greater focus on illiquid investments), and bolster their governance, leading to improved outcomes for members.

These ways in which scale helps improve returns are confirmed by feedback from BVCA investor members that have themselves successfully executed private capital investment programs. These investors have told the BVCA that scale affords them greater resources which improve their access to investment opportunities, market knowledge and ability to negotiate favourable fund terms. These investors also report that scale increases investors' commercial ability to negotiate rights to be offered co-investment opportunities by a fund's manager. These rights give a fund's investors the chance to make further investments alongside the fund in existing portfolio companies and gain further, lower cost exposure to portfolio companies that are demonstrating strong performance post-acquisition. Scale also helps to support the investor's internal resources for effectively analysing the commercial potential of any such opportunities and allowing the investor to make an informed decision on whether to co-invest.

We note the Tony Blair Institute's proposal to allow voluntary transfers to PPF and note the average returns of the PPF approach 9% per year compared to UK DB schemes' average returns of around 6% per year. While a clear and consistent policy on transfers and on funding and investment rules will no doubt be essential for such voluntary transfers to the PPF and to private DB consolidators, the BVCA would in principle be supportive of such a proposal.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor (ttaylor@bvca.co.uk) and Nicholas Chipperfield (nchipperfield@bvca.co.uk)).



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