DC illiquids: key initial questions

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The Government is engaged in a concerted policy drive on productive finance. The Mansion House Reforms set out to, amongst other things, "enable the financial services sector to unlock capital for UK industries and increase returns for savers" and most recently, TPR published new guidance for occupational pension scheme trustees on investing in private markets. The intention is to make illiquid investment more accessible to DC schemes. DC scheme statements of investment principles ("SIPs") must now include default fund policies on illiquid investments. "Illiquid" for this purpose is defined broadly as *a type of asset which cannot easily or quickly be sold*, and in practice this is intended to capture venture capital, private equity, private debt, real estate, and infrastructure.

Deadline for including an illiquid asset investment policy in SIPs

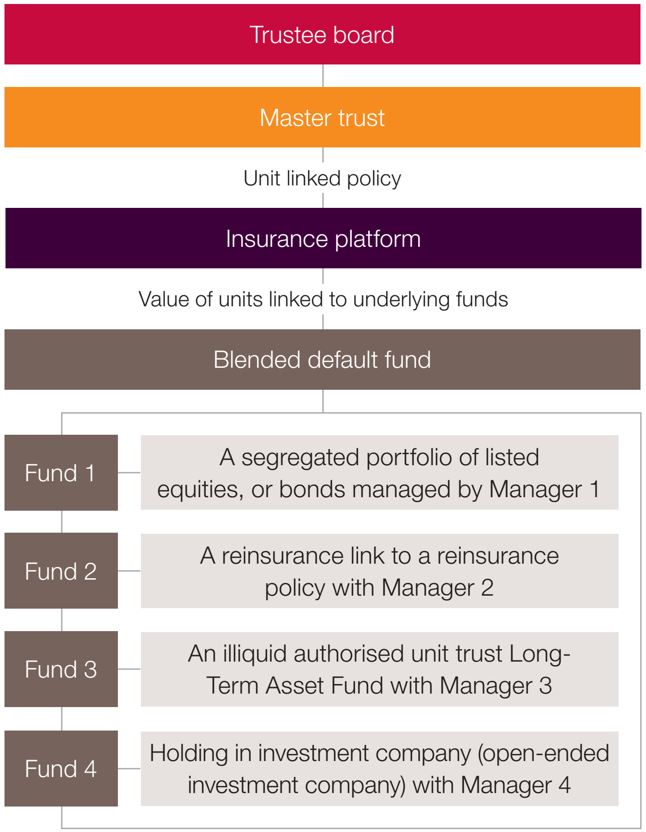
In August 2023, TPR updated its guidance on DC investment governance and communicating and reporting for DC schemes, to reflect regulations (the "Regulations") and statutory guidance intended to broaden DC investment opportunities in illiquid assets (see our Alert for details). The Regulations require master trusts, as well as most occupational pension schemes providing DC benefits, to disclose and explain their policies on illiquid investments in the default SIP from the first time it is revised after 1 October 2023 or by 1 October 2024, if earlier. In practice, schemes are acting now to engage with these new requirements. Not all schemes will introduce illiquid assets into their investment portfolios but, given the clear policy impetus (not to mention the possible member advantages), we expect more schemes will start actively exploring some exposure to illiquid assets in the coming months and years.

Here, we look at some of the challenges associated with introducing illiquid assets into DC portfolios and set out our high-level thoughts on trustees' decision-making.

A question of structure

DC arrangements come in all shapes and sizes, and trustees will need to think about how their assets are organised and which providers they will need to engage with to implement their preferred strategy. Trustee options will necessarily be closely aligned to what their providers, and particularly their platform providers, are able to support and develop.

We set out below a simplified diagram for a typical DC scheme structure, noting that illiquidity can be managed in different ways depending on how it is introduced.



Permitted links rules and the Long Term Asset Fund ("LTAF")

Insurers hosting DC platforms write their policies as linked long-term contracts of insurance, where the value of the units is linked to underlying pots of assets (Funds 1 to 4 in the diagram). Insurers can only back up unit linked policies with assets that are "permitted links" under the relevant Financial Conduct Authority ("FCA") rules. Historically it has been felt that the permitted links rules were not ideally suited to creating links to illiquid assets in all cases. In response to this, the rules for the LTAF, finalised in June 2023, were developed to provide an FCA-authorised open-ended fund which could act as a safe harbour permitted link in this area (as well as being potentially suitable for other investor types).

Notwithstanding this development, DC trustees and providers will still need to be satisfied that the overall arrangements remain suitable for their membership. We discuss below what factors trustees should consider in their decision-making, but similar considerations will apply to the insurer platform providers operating in this space.

Trustee decision-making

Can trustees invest in illiquids?

Trustees must invest scheme assets predominantly in investments that are traded on regulated markets so any investment in private markets must be kept to a prudent level. In addition, trustees' choices may be affected by what their providers are able to support, any restrictions in the scheme governing documents, and the DC charge cap if applicable (see Costs and charges considerations).

Should trustees invest in illiquids?

The Government has not mandated trustees to invest in illiquids (this would be at odds with trustees' fiduciary duties). Trustees need to consider if exposure to illiquidity is in members' best interests.

Liquidity risk

Liquidity risk is a key risk trustees will need to consider when making any decision to invest in illiquid assets.

1 At member/scheme level

Trustees should consider whether the inclusion of illiquids will materially affect the scheme's ability to meet its outward cashflows (ie retirement benefit payments, death benefits, transfers, pension sharing orders etc) in order to make payments to members when they are due. This will be scheme specific and any mitigating factors and/or scheme events will need to be worked through and scenario tested.

2 At fund/platform level

Liquidity can be built in either at fund level or (where an investment platform is used) at platform level. Liquidity will be managed differently in each of these circumstances and should be considered carefully in each case. At present, trustees of a DC scheme who are interested in bringing in illiquid assets are likely to be doing so as part of a blended fund representing the "growth" phase of a default strategy. Trustees will need to consider the requirement for appropriate liquidity in the context of both:

- the scheme's projected cashflows (including as part of any lifestyle or target date switching strategy and for potential transfers out), and
- the internal rebalancing of the blended fund.

It will be important to take into account, and be able to accommodate, how liquid assets are split between the overall blend level and the individual fund level. It will also be important to consider the potential lumpiness of cashflows both at the illiquid fund level and the scheme level.

Costs and charges considerations

Cost versus value

Investment in illiquids tends to be more expensive than other asset classes. Trustee boards will need to consider how to strike the right balance between cost and value.

Charge cap

The DC charge cap that applies to default arrangements applies to the default strategy overall and not to each fund or component. If illiquids are used as a small part of the overall default strategy, this should mitigate the risk of exceeding the charge cap. The Regulations also removed certain performance fees from the charge cap from 6 April 2023, eliminating one barrier to trustees (see our Alert). However, where performance fees are used, a number of complexities remain (see Spotlight on performance fees). Trustees must have regard to statutory guidance when determining whether performance fees fall within the charge cap exemption.

Annual governance report disclosures

Performance fees need to be disclosed as a percentage of the average value of assets in the default arrangement, which can be difficult to achieve once you drill into the details.

Spotlight on performance fees

When are they payable?

Performance fees (or "carried interest") are a typical feature of some alternative asset classes, and are generally payable when the investment returns of the fund exceed pre-determined thresholds or benchmarks.

Member fairness

Performance fees are applied at fund, not member, level. There is considerable complexity in how and when performance fees are calculated. DC members invest in, and disinvest from, a fund at different times. Consequently, performance fees will not always impact the accounts of members who were in the fund during the period over which performance was measured. Legally, trustees are under a duty to act in the interests of their members as a whole, but also to act impartially between members. It can be challenging to align the use of performance fees with this duty.

Safeguards

Trustees need to consider how they can ensure managers are not taking excessive risk, being paid twice for performance which is temporary and, as far as possible, create fairness between members.

For further information, please speak to your usual Sackers contact. You can also visit www.sackers.com

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