Opportunities for investing in the UK Pensions Industry: DC Master Trusts

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The UK's population is both growing and ageing. There are over 13 million people in the UK aged 65 and over, with this number expected to increase to more than 16 million over the next 10 years. Pensions, which provide an income to people after they retire, have therefore never been more relevant or important.

With this significant expansion in demand, we see a greater variety of investors and participants looking at the pensions market: strategic investors are focused on offering a wider range of products to existing customers, financial investors are looking to consolidate in the market and manage synergies and, more recently, a greater range of asset managers are seeking to manage the vast amount of underlying assets backing UK pensions. We have seen great interest from asset managers in the defined benefit ("DB") pensions market and alternative asset managers are focusing increasingly on wider pensions options, where they see potential to manage assets for retail customers.

Consequently, the scope of opportunity for investment in UK pensions businesses is broad and varied. In this note, we focus on DC Master Trusts, exploring:

- what they are and how the commercial economics work;
- what the market looks like now and upcoming changes; and
- key considerations for potential investors and participants in this market.

WHAT IS THE CONTEXT?

All employers in the UK are required by law to automatically enrol their eligible workers in a qualifying pension scheme. The vast majority of employers will satisfy this obligation using a defined contribution (or "DC") pension scheme. These are schemes that provide benefits based on the value of contributions made by members and their employers, and the investment return made on those contributions (rather than a guaranteed amount calculated based on salary and length of service). In DC schemes, it is therefore the members who bear the risk of investment performance.

DC schemes come in two main forms: trust-based and contract-based.

Trust-based schemes are established under trust and run by trustees, who owe fiduciary duties to their members. All trust-based schemes are regulated by the Pensions Regulator.

Contract-based schemes are structured as individual contracts between each member and the pension provider. The provider and an independent governance committee are responsible for operating the arrangement. Contract-based schemes are regulated by the FCA.

WHAT IS A MASTER TRUST?

Master trusts are trust-based schemes which are used to provide money purchase benefits to the employees of multiple unconnected employers. They must be authorised specifically by the Pensions Regulator. There are currently 30 authorised master trusts operating in the UK; some of these are non-profit making, but the majority operate on a commercial basis.

A master trust is established by a founder and governed by a board of trustees or trustee directors, the majority of whom must be independent. Most commercial master trusts also have a "scheme funder" (which must be a body corporate or partnership). The scheme funder is liable to meet the scheme's running costs if these can't be satisfied using member charges and is entitled to receive profits from the scheme where member charges exceed running costs.

If a master trust is used as an automatic-enrolment scheme, it must operate a default investment arrangement. This is the arrangement in which members' contributions, and those made by their employer, will be invested, unless a member themselves makes different investment choices. About 94% of master trust memberships are invested in their schemes' default arrangements.

The trustees are responsible for determining overall investment objectives and making strategic investment decisions, including in relation to the design of the default arrangement. They will select (with input from advisers) the funds that comprise the default arrangement, and any other funds which members can choose to invest in (though where the trustees invest via an insurance policy wrapper this may be from a curated list of fund options made available by the insurer).

HOW DO THE COMMERCIAL ECONOMICS WORK?

As a trust arrangement governed by trustees, the commercial nature of a master trust and its economic value for an investor look slightly different when compared to, for example, investment in a corporate entity.

"Revenue" is generated primarily through charges which are deducted from members' pots. In default arrangements, these charges are capped annually at 0.75% of the member's pot value. These amounts are used in the first instance to meet the scheme's running costs, including the fees of service providers, investment managers, other professional advisers and the trustees.

If the amounts received from members aren't enough to cover these fees, the scheme funder(s) will typically meet the shortfall. On the other hand, if the amount of charges collected exceeds the fees payable, the excess can be paid to the scheme funder(s).

It is common for a number of key functions in relation to a master trust (e.g., scheme funder, scheme administrator, investment platform provider/insurer, investment manager) to sit in the same corporate group.

Beyond running the master trust, as the assets under management grow, another focus from larger alternative asset managers has been on the extent to which they can manage the assets of master trusts. Subject to the annual capped charge, the interest revolves around being able to offer a greater range of investments to customers and charge fees for managing those investments.

WHAT DOES THE MARKET LOOK LIKE, AND WHAT'S CHANGING?

Over 10 million people are saving into DC trust-based pension schemes, with the total value of their assets estimated to be about £205 billion. DWP projections estimate that this could grow to over £400 billion by 2030.

This universe is dominated by master trusts, which account for the vast majority of memberships (more than 90%) and assets (£166 billion: over 80% of the total DC trust-based asset value) in DC trust-based schemes. Within this space, a small number of schemes themselves dominate, with five master trusts holding more than 80% of the relevant asset pool.

An evolution in government policy, reflected by the measures in the Pension Schemes Bill (expected to become law this year), is driving change which we expect will have a major impact on the shape of the DC master trust market. These include the following:

- **Consolidation focus**. The government is focused on consolidation of the DC pensions market, with a clear aim of achieving a landscape with "fewer, bigger, better-run" schemes. This will likely result in mergers between existing master trusts and material increases in the size of individual master trusts.

- **Value for money framework**. The Pension Schemes Bill introduces a statutory framework under which relevant schemes, including master trusts, will need to make and publish annual assessments of the value for money they offer members. This is intended to make it easier for employers to compare DC pension arrangements and select those that offer the best value for their employees. The focus is on long-term value and service provision, which we expect will drive competition between schemes looking to attract a greater proportion of the market.

- **Scale requirements**. The Pension Schemes Bill will also require every scheme used for auto-enrolment to have a "main scale default arrangement" with a total value of £25 billion by 2030. If a scheme doesn't reach this scale requirement by the relevant deadline, it will be required to consolidate, though there will be transitional relief for schemes which have £10 billion in assets under management by 2030 and can demonstrate a clear and credible strategy for achieving the required £25 billion by 2035, and a separate pathway for new entrants with an innovative offering and ability to achieve scale. These requirements are likely to mean it will be difficult for new master trusts to enter the market.

KEY CONSIDERATIONS FOR POTENTIAL INVESTORS AND PARTICIPANTS

- **Regulatory**. DC master trusts are regulated by the Pensions Regulator. Ensuring that the master trust has a clean regulatory record will be important in managing any conduct risk in investing in these businesses.

- **Sources of growth**. Considering the sources of growth within a master trust and whether the business is dependent on particular distribution channels or organisations will influence scope for growth.

- **Managing the charges.** It will be important to strike a balance between the commercial value of charges levied on members with delivering value for money, ensuring that the charges will be competitive and below the charge cap.

- **Asset allocation.** Diversity of investments can drive growth of DC master trust asset returns. Due to the role of trustees, it will not be possible simply to install a new asset manager, investment strategy or range of investments for a DC master trust, and any such proposition will need to be compelling for the trustees and customers. However, the right asset offering can differentiate a master trust and drive further growth.

- **Technology and operating platform.** As DC master trusts are business of scale, understanding the quality and potential scalability of any administration platform is important.

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