DC schemes need custody platforms

Its time to remove life companies from DC trusts

We have a bizarre operational design in UK Defined Contribution – insurance companies mediating investment for trusts. This gives us a Pan-Mattian situation, worst of all possible worlds[1].

Trusts do need operations to mediate raw investments into the priced funds of DC members, but they do not need life mediation. This briefing note will start by exploring what trusts could do and then discuss the harm interposing life companies does, why its time to break free.

What can trusts do?

The only limits on a trusts ability to invest are on the prevention of borrowing. Even here there are ways around this using derivatives as the LDI debacle shows. That means that any investment that can be made by anyone, can be made by trusts. This general landscape is limited by the fiduciary duty of the Trustees who must decide that the investments are in the best interests of the membership, are made prudently and without conflict. No doubt I'll return to fiduciary duties as it is a crucial topic, but this framing means that the Trustees must convince themselves an investment helps the purposes of the trust, but doesn't prevent any investment from being considered.

With unlimited power to invest, a DC scheme must then work out how to allocate investments and investment returns between members. This is the complex bit that fund managers and life companies have solved. But this is not the only possible solution.

At a certain size, most institutional trusts hold their assets with custodians, who use segregated accounts to keep track of where assets are. Because a DC scheme is more like a fund than a DB plan, fund accountants are required to price the funds daily, or as often as required, and some internal architecture is then required to translate, say, your holding of shares of Barclays PLC into the equity fund, into the growth fund and into the target dated fund. While this is complex, this is routine and once set up well within the competencies of the custody banks who offer these services.

Each manager and each asset class underlying member holdings can get a segregated account so performance can be correctly attributed to manager skill. None of these "funds" or "accounts" needs an independent legal structure, just an accounting structure to make sure benefits are fairly allocated. The top-level legal structure is a trust – what greater protection could be offered?

If your holding is an asset class or with a manager is too small to be efficiently managed or cost effective, buy units in their comingled vehicle. If their comingled vehicle doesn't trade or price every day, no biggie, just work out how you want to create proxy prices for the holding and how you want to manage liquidity between members.

If you don't like how your manager prices their services, you can negotiate. If you want a mechanism to cap carry, or to move all fees away from ad valorem, you are in the driving seat. If you want physical assets and not even recognise those costs in the charge cap calculation, you can[2] (we understand NEST do), you just need the trust's actual balance sheet to put them on.

Of course, the trust using a custody platform is taking on the complexity of managing activities which life companies take away. Bringing them back "in-house" adds cost and so there is clearly a tipping point of size where this works. But my hypothesis is that many more schemes have reached this tipping point than take advantage of the investment freedom. Why don't we have more illiquid assets in DC? Because Trustees are not pushing hard enough

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[1] Like the opposite of Voltaire's Dr. Pangloss…

[2] SI 2021/1070 Regulation 6: [The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (legislation.gov.uk)]

at the operations needed to put them in place. Are they too expensive? Not all of them, not if they're physical assets on your balance sheet. For these assets you could go back to being a true investor, one who only cares about net returns, not cost and net returns.

The harm that life platforms do

Let's just start by acknowledging life platforms do a lot of good. I'm not so young as I can't remember the nightmare of individually faxing managers to trade their funds, the impossibility of white-labelling, the DB side lending liquidity. I get it, life has solved a lot of problems small schemes faced. But DC has grown up now. St Paul wrote to the Corinthians that "When I became a man I put away childish things", it's time for us to put away the childish thing of life platforms. Let's talk about the harms we can grow out of.

Firstly, transparency. Do you know what your managers cost? How confident are you that your prices are accurate? How much box profit was the liquidity offered to you by the life company worth? What is a material pricing error? Is 0.01% too much to lose track of? Everyday? No grown-up institution would delegate so much of the heart of their operations to a single service provider and get so little transparency in return. Can you send in your own auditors?

Secondly, sophistication. Where are your grown-up investment asset classes and approaches? Ok, we all hate hedge funds now, but what about private equity or venture capital? Even that too much for your taste? How about your private credit or currency hedging? How about your property and infrastructure? If you're getting these in daily traded funds, you're not getting full fat. Why accept this compromise for your members?

Finally, flexibility. What does it look like for you to change asset allocation? Level of currency hedging? Launch a new fund? Change the price on a fund? Appoint a new manager? When your Trustees have already received regulated advice, legal advice, whatever advice, on all of these matters and convinced themselves of their competence to make the decision and the advantage of it to your members, why are they second-guessed by a life company? How much time does this add? Aren't some of your decisions time-bound? Don't you think they should be?

Life company platforms are now the opaque, overly simplified, inflexible solution to problems many DC schemes have grown out of. It's time to stop tinkering around the edges on this problem and move forwards constructively.

What do I mean by tinkering? The Long-Term Assets Fund (LTAF) is a great example. If we didn't have life platforms then liquidity would be manageable by the Trustees, recognising that DC is net cashflow positive and few members will ever do anything other than use the default. Instead liquidity management is not just delegated to life companies to manage, but insured as a risk on their balance sheets. Why? We're constructing a weird new vehicle which has no better liquidity than the underlying holdings because more mouths in the de-value chain is beneficial? Because if you want to eat apples you're almost certain to like a mix of apples and pears?

LTAFs may well have a place to delegate the selection of managers for complex multi-asset mixes to a single consultant or manager, doing the research and managing the allocation on your behalf. But they have no place enabling the contents of GP / LP to be put onto life platforms. The fact that GP / LP structures, direct title of property and shares, etc, etc, etc are excluded is the problem. They should be on the trust's balance sheet, not insured on the balance sheet of a third party who has to amend retail regulations to permit them to invest in them. It might be helpful discuss the collective group think of platforms and fund managers that created the LTAF almost no clients want later, but for now let's leave with the realisation that this is a nonsense created by reliance on life platforms.

Next steps

I am under no illusion that the dam is about to burst on custody accounts, but I estimate there are of order 30-40 schemes, maybe half of the assets in DC trusts, who should be actively working out what they can move to and benefit from the custody platform business. If your ears are burning, I'd love a conversation.

I also know that there is some disappointment in the world of custody banks at the pace the market has come to them. I think this is because too much is loaded onto the client in terms of managing the platform and it's scary to think about the responsibility that comes with the power you offer (to paraphrase Peter Parker). I have some ideas in this space I'd love to discuss with you.

Finally, I recognise that there will be Master Trusts trapped by ownership in the insurance world. You have my sympathy. I think you're going to watch the DC world becoming more sophisticated around you, slowly, but surely. At some stage the value for members challenge and comparison to those more sophisticated, custody platformed schemes is going to suggest you shouldn't continue for the benefit of your members. Will you wait that long to have the conversation with your owner about the weird operations they're forcing you into?

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