DENTONS

Lessons from Australia
The move to Megafunds in the UK

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The UK government is proposing to consolidate the size and operations of defined contribution and local authority pension funds to create larger pension schemes ("megafunds") in England and Wales. This article summarises the reforms, the comparative approach internationally (with a spotlight on Australia), the detail of the proposed changes and their rationale. Finally, we discuss the next steps and further legislation being proposed.

1. Outline of reforms

The Chancellor of the Exchequer, Rachel Reeves, gave her first Mansion House speech on the evening of Thursday 14 November 2024. Describing the UK financial services industry as "the crown jewel in our economy", the Chancellor outlined several significant reforms to the pensions market.

The key takeaways are the proposed changes to the Local Government Pension Scheme (LGPS) and to multi-employer defined contribution workplace pension schemes, intended to consolidate the funds into megafunds.

Following the publication of guidance on the pooling of LGPS assets in 2015, the 86 administering authorities came together in groups of their own choosing to establish eight asset pools. The government proposes measures to further consolidate these megafund asset pools.

Additionally, the government will consult on setting a minimum asset value requirement for default arrangements in multi-employer defined contribution schemes, as well as a limit on the number of default arrangements. There are currently around 60 different multi-employer schemes, each investing savers' money into one or more funds. The government's proposals would likely lead to a reduction in the number of defined contribution master trusts and contract-based defined contribution providers.

2. Megafunds: the view from Australia

2.1 Summary

The Chancellor highlighted international evidence to show why consolidation of the LGPS and defined contribution schemes would be positive. References were made to Canadian and Australian pension funds. Canadian pension schemes invest around four times more in infrastructure, while Australian pension schemes invest around three times more in infrastructure and 10 times more in private equity, such as high-growth businesses, compared to defined contribution schemes in the UK. We provide further detail on the Australian experience in the remainder of this section.

2.2 Australian super fund system and merger activity

The Australian super fund system has seen significant merger activity in the past few years since the introduction of the "Your Future, Your Super" legislation in June 2021, which introduced an annual performance test for MySuper products in 2021 and trustee-directed products in 2023.

APRA, the Australian prudential regulator, administers this test by assessing the long-term performance of superannuation products against tailored benchmarks, with consequences that if a superannuation product fails the test two years in a row, it is not able to accept new members.

2.3 Key drivers for mergers of Australian super funds

This annual performance test has been one of the key drivers forcing smaller, underperforming funds to consolidate with larger funds (with 13 MySuper products failing the test in 2021, five in 2022 and one in 2023). However, there have been other key drivers for mergers in the past 10 years including increasing regulatory costs, the need for more economies of scale to reduce costs and the focus on becoming a bigger player in international markets to directly access private equity and infrastructure deals. Also, in Australia, corporate funds have rapidly declined and merged with bigger institutional super funds to provide better outcomes for members.

2.4 Merger statistics

Some key statistics in the Australian market:

- the total number of corporate funds has come down from around 50 in June 2013 to only nine as of September 2023;
- the total number of APRA-regulated funds in the private sector has more than halved over the past decade, from 259 in June 2013 to 103 in September 2023;
- the number of industry funds has shrunk from 46 in June 2013 to 22 in September 2023; and
- the number of retail funds has more than halved from 163 to 72.

These numbers are continuing to come down, notwithstanding that merger activity has slowed due to super fund trustees being better positioned to understand the performance test benchmarks and ensure they meet them (and do not fail). In 2024, every MySuper product passed the performance test for the first time. However, of the trustee directed products, 37 out of 192 platform products failed to meet the test benchmarks, including 27 products which failed for a second time and are now closed to new members.

2.5 Growth of megafunds

Examples of megafund mergers (and growth by continuing mergers) in the Australian market are:

- AustralianSuper merged with a number of corporate plans (including Australia Post) and merged with Club Plus Super and LUCRF (amongst others), creating Australia's largest megafund with A$341 billion under management and 3.4 million members;
- Sunsuper and QSuper merged to create the Australian Retirement Trust (ART), now Australia's second biggest megafund which has also merged with a number of smaller funds and corporate plans (such as Qantas), with A$314 billion under management and 2.3 million members; and
- First State Super and VicSuper merged to create Aware Super (also an Australian megafund with A$180 billion under management and which has continued to merge with smaller funds, such as WA Super and VISSF.

Australia now has 14 super funds with more than A$100 billion under management. AustralianSuper and ART together now manage A$655 billion in assets and account for more than half of all new retirement savings. Morningstar predicts one of the Australian major super funds could even exceed the A$1 trillion mark next decade – meaning that single entity would control an amount of capital greater than that of any single Australian state and more than half of Australia's GDP.

To put their size into perspective, AustralianSuper and ART are among the largest pension funds in the world, ranking 16th and 22nd in assets under management behind institutions from Japan, South Korea, the US, Canada and the Netherlands.

2.6 Impact of megafunds

Having a few megafunds in Australia managing Australians' retirement savings and such significant pools of capital brings into question a number of critical social and economic questions. A recent Australian Financial Review article included a statement: *"As the super system grows, a small number of megafunds, such as AustralianSuper and the Australian Retirement Trust, are on track to have a bigger influence over ownership of key sectors of the economy than 19th-century mutual banks AMP and MLC had in the 1960s."* This article also goes on to report that the Reserve Bank of Australia (RBA) highlighted two months ago that *"super funds selling their bank bill holdings had increased funding costs for the banks and the broader financial system just as it was being put under stress by the pandemic"* with the RBA warning *"As the super sector expands, its investment and liquidity operations 'have a greater potential than before to amplify shocks to the financial system'."* These and other economic and social issues are explored summarily in this article, making it a thought-provoking piece as to the risks and benefits of mega super funds.

And so, while the creation of mega super funds should create economies of scale and efficiencies to bring better outcomes for members, constraints and societal challenges also arise, including governance issues (if they become too big and are unable to manage their membership requirements), economic and competition issues (as indicated above) and constraints with the ability to deploy capital (for example, with the Australian market providing a constrained and limited investment market).

ASIC, Australia's customer-focused and conduct regulator, recently warned that super fund directors *"should be held to the same standards as company board members ... opening the door to potential individual prosecutions as it targets the sector's systemic failure to treat customers fairly"*.

The NAB Super Insights Report 2023 reports that Australian super funds now invest nearly 50% of their funds in offshore assets as there are not sufficiently scaled investment opportunities in Australia, with Australia's A$4 trillion in super funds equalling about 150% of Australia's annual gross domestic product and 25% of the total financial system.

2.7 But size does matter

AustralianSuper's chief strategy officer, Paula Benson, is reported as saying that the fund's larger size enables it to access bigger overseas investment opportunities, maintain liquidity while accessing unlisted markets and hold on to assets for longer, so their value increases. Ms Benson is reported as saying: *"We're not pursuing growth for its own sake – fundamentally, we believe that size and scale helps our members."* Ms Benson believes scaling up to A$500 billion in the next five years will drive savings, forecasting a cut in the fund's running costs by more than A$1.5 billion annually by 2030.

2.8 Insourcing

A recent paper published by Doug Talbot in October 2024, suggests there are four principal investment models operating in the Australian super fund industry: fully outsourced; investment allocator; manager and allocator; and global manager, and highlights a prominent feature of the evolution of the Australian super fund market has been the growth of insourced asset management and a move to the global manager model, mirroring the development of the Canadian pension fund market (considered the global pension fund benchmark of investment models due to its size, scale, asset diversification and sophistication). In this respect, however, the Australian super fund market is constrained by fees and remuneration models, unlike the Canadian pension fund market, which makes it harder for Australian super funds to attract top "insourced" talent. As a result, most Australian super funds adopt the hybrid manager-and-allocator model, where the fund is manager of some asset classes and outsources others. The report states: "*Many funds in Australia when they reach approximately A$60 billion see some scale benefits to moving to this model.*"

3. UK proposals

On 20 July 2024, the Chancellor launched Phase One of the Pensions Review – the Pensions Investment Review. The terms of reference for Phase One were published on 16 August 2024. These note the scope of the review as including defined contribution workplace schemes and the LGPS. A Call for Evidence was also published on 4 September 2024, closing on 25 September 2024.

The government published its Pensions Investment Review Interim Report and "Pensions Investment Review: Unlocking the UK pensions market for growth" and "Local Government Pension Scheme (England and Wales): Fit for the Future" consultations on 14 November 2024. These documents outline in detail the proposals to deliver "scale and consolidation" in the defined contribution market and the LGPS in England and Wales:

- **The LGPS**

- The UK government proposes to legislate to consolidate the LGPS by requiring that the 86 LGPS administering authorities complete the transfer of all assets to the relevant asset pool by March 2026. In addition, the administering authorities will need to follow these key proposals to consolidate:
  - **Delegate:** Fully delegate the implementation of their investment strategy to their pool;
  - **Take advice:** Take their principal investment advice from the pool; and
  - **Transfer legacy assets:** Transfer legacy assets to the management of their pool, with listed assets being prioritised.
- The proposals will require all pools to be investment management companies regulated by the FCA. Currently, three of the eight pools are not FCA-regulated.
- The consultation outlines that formal mergers should take place if they provide a more appropriate route to meeting these proposals. It is worth noting that the eight pools each have different models. As mentioned, five are FCA-authorised investment management companies, two have an outsourced model which relies on external providers and one operates a model where the partner funds retain management of most assets, with oversight from a joint committee. Each pool is expected to demonstrate why a merger with another pool, or use of existing capability in an established pool company, would not be a more cost-effective or otherwise preferable approach to achieving compliance with the reform proposals. The government is not currently seeking to use this process to move to a single pool for all administering authorities.However, it is likely, in practice, that the pools which are already FCA-authorised may have an advantage.

- The proposed deadline for achieving pooling of all LGPS assets will be challenging given that pooling commenced in 2016 and the eight pools currently manage only around 50% of LGPS fund assets. Equally ambitious is an expectation that the asset pools, working together with their administering authorities, will each submit a proposal (by 1 March 2025) on how they will complete the transfer of all assets by March 2026 and deliver the necessary operational and governance changes. Those proposals are required to include a view of the likely costs, the timeline and potential barriers and solutions.

- **Defined contribution workplace pension schemes:**
  - **Maximum number and minimum size:** The UK government proposes to legislate for multi-employer defined contribution schemes used for auto-enrolment to have a maximum number of default arrangements and for each default arrangement to operate at a minimum size.However, the government is undecided as to whether these requirements should apply at arrangement or fund level and this is one of the issues that is being consulted upon.
  - **Overriding individual consent for transfer:** The government is also proposing to remove the requirement to obtain individual consent from savers to bulk transfer assets between different contract-based arrangements.

4. Rationale for reform

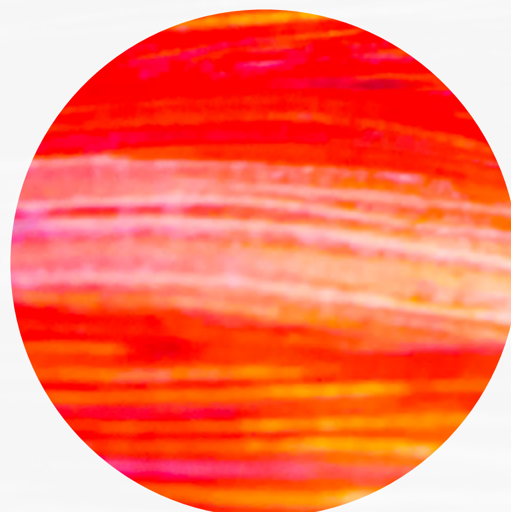
The rationale is the need for scale to drive investment in productive assets and lead to better outcomes for members.

There is evidence that increasing scale is a good strategy for pension funds. The UK government's analytical paper "Pension fund investment and the UK economy" outlined the trends in pension fund investment internationally in relation to scale. It found that the scale of a pension fund determined its ability to diversify investments, particularly in relation to private market and alternative assets.

The "sweet spot" appears to be >£25 billion of assets under management, at which point additional key benefits emerge which outweigh potential disadvantages (short-term increase in costs, concentration of competition in the market, riskier larger investments). Those key benefits are:

- better governance;
- the ability to move investment in-house, potentially reducing investment costs;
- the ability to invest directly in assets rather than needing to be part of a pooled fund; and
- improved bargaining power, including the ability to pay lower investment fees.

The LGPS collectively holds A$446 billion assets and is the seventh largest pension fund in the world. Consolidation of all assets into the pools would allow it to more effectively wield its assets to deliver better returns.



5. Next steps and proposed legislation

The consultations will run until 16 January 2025. The final report will be published in the spring which will crystallise the proposals and next steps. The scope of Phase Two of the Review will be published at a later date. It will broaden out the Review and consider further steps to improve pension outcomes. The finalised reforms are expected to be included in a new Pension Schemes Bill in 2025.

This article was prepared by members of our Global Funds teams in Australia and the UK, as well our UK Pensions team. If you have any questions on the issues raised in this article, or investment funds or pensions matters more generally, please do not hesitate to contact any of our team:

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