BLACKROCK

28th February 2019

Roy Bartholomew
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

Submitted via email to: cp18-40@fca.org.uk

RE: CP18/40: Consultation on proposed amendment of COBS 21.3 permitted links rules

Dear Roy,

BlackRock[1] is pleased to have the opportunity to respond to the consultation on proposed amendment of COBS 21.3 permitted links rules, issued by the Financial Conduct Authority (FCA).

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this consultation paper, which this response should be read in conjunction with, and would welcome the opportunity to contribute to the FCA's ongoing thinking on these questions.

Yours sincerely,

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[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

Owing to auto-enrolment more and more UK citizens are saving for their retirement. However, saving rates are only part of the challenge: their pension investments must also work hard for them. To realise this pension savers need access to a wider range of investments that suit their long-term horizons. Alternative and less liquid investments are an important part of diversified portfolios, given their low correlation to equities and bonds – reducing risk, and improving returns. Less liquid long-term investments such as real estate and infrastructure are especially suited to the long-term profile of DC pension funds and provide protection against the risk of rising inflation, one of the greatest risks to future living standards.. Enabling more of this type of investment will be mutually beneficial for both individual savers and the wider economy. We therefore welcome the FCA's initiatives to encourage investment from DC pension schemes into 'patient capital'.

Expanding the range of permitted investments

We broadly support the expansion of the permitted investment links categories for DC schemes proposed by the FCA. Subject to proper regulation and investor protections, we believe the new categories are a good first step to facilitating more DC scheme investment into patient capital.

Permitted loans

We support the addition of the new immovables category as an acceptable form of security in the permitted loans category. However, we would ask the FCA to consider a wider range of security types for inclusion in this category. In the direct lending or consumer loan market, the debtor may offer other forms of security, or may be entirely unsecured. Indeed, loans may have a wide range of features: secured or unsecured; senior or unsubordinated; providing fixed and floating interest payments – all likely providing predictable cash flows over the long term, but without a charge against the underlying assets. These asset classes are currently available to other DC investors.

Illiquid asset threshold limit

We do not object to the proposed aggregate cap on illiquid assets held as permitted links or conditional permitted links – so long as the limit is applied at the level of an overall portfolio, or at the aggregate life vehicle level. This would provides a welcome simplification of the current framework of asset class-specific restrictions.

However, we would question whether such a limit is necessary. We believe it would be more appropriate to allow investors and service providers the flexibility to build illiquid exposure that is appropriate for the end investor. A hard limit could raise additional complications, for example in dealing with the dynamic nature of inflows and outflows, and with the differing age groups within a pension scheme who will have varying investment requirements at different points in the life-cycle of their investment.

Consumer risk mitigation proposals

From the perspective of pension savers, we have some concerns about the FCA's consumer risk mitigation proposals. The FCA suggests that any use of the expanded range of permitted investments should be subject to the condition that they do not prevent retail investors exercising their existing rights within their pension scheme contract. In some cases, we believe this is likely to be unworkable, given the inherently long-term and illiquid nature of patient capital investments. For example, there is likely to be a mismatch between daily liquidity requirements and the wider objective of facilitating more DC investment into patient capital.

We are also concerned about the workability of the proposed appropriateness and suitability tests. It is not at present clear which entity would be responsible for carrying out such tests, or how they would align with suitability tests that exist under existing legislation such as MiFID II or IDD. We believe it would be unworkable and undesirable for asset managers to carry out this test, for instance, because fund managers do not have access to information on the underlying investors in life products.

Responses to questions

1. ***Do you agree with our proposal to allow investment in immovable structures or installations as above? If not, how could we change it?***

Overall, we agree with this proposal, but believe some clarification is necessary.

Firstly, it is not clear from the FCA's consultation paper whether permitted investments will be limited to only immovable structures or installations in the UK. From a cost and scalability perspective, underlying funds have to be flexible enough to give exposure to UK investments or otherwise. If funds are only permitted to invest in one 'area' of patient capital, for example UK land, infrastructure, or loans, fund providers may have to build new funds aimed at one specific investment exposure; increasing cost, limiting scalability, and narrowing the investment exposure universe. Instead, investors should have access to as wide a range of investments as necessary to create a portfolio that will enhance their retirement outcomes.

Secondly, it is not clear whether the definitions of permitted immovable structures or permitted investment projects are aligned with those given by the European Insurance and Occupational Pensions Authority (EIOPA) for Solvency II. It would be helpful to understand the treatment of such investments under Solvency II's capital adequacy requirements, and whether any capital charge discounts for investing in certain asset classes or fund structures is possible. In this respect, we refer to the FCA to the detailed worked carried out by EIOPA in respect of capital charges for infrastructure investments under Solvency II.

2. ***Do you agree with our proposal to remove, for firms that meet the conditions as above, the current 10% limit on the proportion of fund assets that may be held in land and property, relying instead on the overall limit on illiquid investments? If not, what percentage limit would you suggest is appropriate?***

Agree subject to our response to question 6.

3. ***Do you agree with our proposals only to allow additional investments if the conditions in paragraph 3.17 are satisfied?***

We agree in principle but have notable concerns about the proposals under paragraph 3.17 of the consultation paper – see our response to question 8.

4. ***Do you agree with our proposal to relax the requirement for unlisted securities to be 'realisable in the short term' and to replace this with a liquidity test at the level of the investment fund, as set out above? If not, how could we change it, if at all? Do you think either of the alternative asset-level restrictions would work better?***

We agree with the removal of the requirement for unlisted securities to be "realisable in the short term", which currently hinders life companies' ability to invest in illiquid products. However, the FCA's proposals for maintaining contractual rights regarding frequency of dealing and switching, which we address in our response to question 8, may undermine this change by imposing a de-facto requirement for investments to be readily realisable.

5. ***Do you agree with our proposal to remove, for firms meeting the investor protection conditions, the current 20% on holdings of assets through QIS/UCIS and instead rely on the overall limit of 50%? If not, how could we change it?***

Agree subject to our response to question 6.

6. Do you agree with our proposal to set an amalgamated overall threshold limit for firms meeting the conditions as above? If not, what could we change? Do you agree with the percentage level proposed, or if not, what should it be and why?

We do not object to this proposal, but would firstly ask the FCA to clarify where the amalgamated limit will be placed. We believe this should be applied at the level of the life vehicle or portfolio, and that it would not make sense to apply a limit at the level of a specific sub-fund or permitted link. Application at the level of sub-funds or permitted links would likely increase costs and reduce scalability for end-investors, to the extent that it would exclude existing funds with illiquid investments above the threshold being used as building blocks in a wider portfolio.

However, we would question whether such a limit is necessary at all. Investing in patient capital is by its nature long term, and it is not possible, at the level of the investment fund or structure, to ensure that securities can be realised at all times to meet liquidity needs. Both Trustees' suitability assessments and platforms' ability to manage liquidity should be helpful in ensuring that asset classes are appropriate for the likely liquidity needs of underlying DC investors, as is the case where DC schemes or master trusts invest outside of life vehicles.

In addition, there are likely to be practical issues with a hard limit, particularly relating to the dynamic nature of inflows and outflows, and given that different age groups within the scheme will have different investment requirements at different points in their investment lifecycle. We believe therefore it would be more appropriate to allow investors and service providers the flexibility to build illiquid exposure and provide solutions that is appropriate for the end-investor.

7. Do you agree that the obligation on firms to provide adequate risk warnings about liquidity and investment risk would contribute to better understanding of those risks by investors in unit-linked funds?

We support this proposal. It is important that investors are educated about the risks associated with investing in 'alternative', or longer-term patient capital investments.

8. Do you agree with our proposal to require provider firms to ensure that any unit-linked investment does not interfere with retail investors' rights to switch funds, take benefits or to withdraw or transfer funds? And our proposal that links to the new categories of investment are only offered/taken up in suitable and appropriate investment contexts? If not, how would you change it?

We are concerned about that the proposal that firms must ensure investments in the new permitted links do 'not prevent a retail investor exercising rights under the unit-linked contract' may undermine investors' ability to achieve better outcomes. While we understand the motivation behind this, such a requirement will hamper the overarching objective of facilitating greater investment from DC pension schemes into 'patient capital' investments.

As noted, patient capital is by its nature long-term and often illiquid. It therefore may not be feasible for such investments to be realised in time to meet some contractual rights under a life company's pension scheme – for example daily liquidity or switching. This issue would need to either be recognised in the pension policy or contract, or providers of illiquid investments would need to be given some grace by the FCA that they may not, in good faith and with strong governance, be able to realise the investments in the timeframe required per contractual obligations.

The FCA also proposes assessments of appropriateness and suitability, which would entail a consideration of the maturity of an investment against the purpose for which the investment is used by the retail investor. We are concerned that, as it stands, the proposals are not clear on which entity would be responsible for carrying out these assessments, nor on how they would align with 'suitability' assessments required under other legislation. For example, under the Pensions Act 1995, Trustees are required to assess the suitability of their investments. Many pension schemes employ investment advice from outside consultants in order to discharge this

duty. Separately, life companies, many of whom provide DC pension schemes, are required under the Insurance Distribution Directive to carry out target market analysis.

If it is envisaged that the suitability assessments would be carried out at the level of the investment fund provider, this would equally be cause for concern. Fund managers managing investments for these DC pension schemes do not have access to information on the underlying individual investors, and therefore would not be able to conduct suitability assessments. This is further complicated by the consideration that any suitability assessment made by fund managers in relation to DC scheme investors could be construed as investment advice, and therefore subject to a different set of regulation altogether. Moreover, the investments of pension schemes, particularly larger schemes, are likely to be managed by multiple fund managers, rendering it impossible to accurately make such assessments.

With this in mind, the FCA could reconsider the treatment, from an investor protection perspective, of DC investors using life companies' pension products versus different types of retirement savers. For example, DC investors investing through life companies are considered retail investors, in contrast to DB scheme members, DC investors investing through NEST, or Schemes investing directly. The vast majority of DC investors, regardless of which savings vehicle they use, have a long-term investment horizon and limited need for liquidity. The FCA should consider creating equal investment opportunities for the different platforms serving DC investors, so all have the same opportunities to enhance their investment outcomes. DC schemes such as Master Trusts subject to detailed governance requirements could have the option of electing to be treated as professional investors to allow this level playing field to come about.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the consultation and will continue to work with the FCA on any specific issues which may assist in its further work on facilitating further patient capital investment going forwards.