THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

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Dear DC Policy, Investment and Governance Team

SPP RESPONSE TO ENABLING INVESTMENT IN PRODUCTIVE FINANCE

We welcome the opportunity to respond to this consultation.

Executive Summary

We believe that the matter of DC pension schemes investing in productive finance and illiquid asset classes in general is an important one that covers a variety of considerations. Ultimately we believe these asset classes have a part to play in DC scheme investments, although not all schemes will decide to use them – it is important that if they are used it is because they are right for a scheme and its members first and foremost. As part of this, there are barriers to using these asset classes that it is desirable to remove, so that schemes can use them if they wish. These include liquidity, complexity, perception of members and charges. Our response to this consultation is focused on the specific questions set out in the consultation, but we wanted to note that charges are not the sole factor in whether schemes use these assets.

We also want to stress the importance of creating as far as is possible a level playing field for investment asset classes. Performance fees are implemented by active fund managers for investment strategies that are not necessarily illiquid. Examples include but are not limited to multi strategy hedge funds and small cap equities. The main reason behind this is to better align the interests of the fund manager and investors. We note that in recent DWP consultations on DC and productive finance there is a clear intention to avoid trustees favouring certain vehicles/investment types over others. In a similar vein, we would encourage consideration as to how to avoid the trustees favouring one asset class/structure over another based on whether performance fees of one type are included in the charge cap and not for other asset classes. A level playing field in this regard could further open up the investment landscape to DC trustees, more akin to that of DB trustees.

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Detailed Response

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so, would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

We are aware of DC schemes which have an appetite to invest in assets like private equity and venture capital because they believe that including an appropriate allocation to such investments in their default fund would be in the best financial interests of members. Such investments may be more attractive to larger DC schemes which have sufficient expertise and support from advisers to properly assess and negotiate such investments. Private equity and venture capital would only be appropriate for a single or low double digit percentage of the default fund to mitigate liquidity issues. If larger DC schemes over time make such investments a well-trodden path, some smaller DC schemes may in the future also seek to make such investments.

DC pension schemes normally communicate to their members that their charges will be [x]% (which could be described as the "commercial cap"). The commercial cap tends to use the same definition of charges as the statutory charges cap. DC pension schemes cannot exceed the commercial cap, even if there is headroom below the statutory cap on charges. The inclusion of performance fees in the definition of charges could create a disincentive for DC schemes to make such investments because if there is significant outperformance (which would obviously be in the interests of members) this could push the charges over the commercial cap and those excess charges would have to be absorbed by the DC scheme provider rather than factored into the investment return.

Excluding performance fees from the charges cap would remove a concern which may deter some DC schemes from investing in private equity or venture capital. However, other concerns may remain including concerns about excessive focus on cost rather than long-term value for members; lack of scale for many DC schemes; lack of expertise in decision-making; maintaining appropriate liquidity in the DC pension scheme's portfolio and member perception / understanding.

Another key concern about the charges cap which may deter some DC schemes from making such investments relates to uncertainty about the extent that "look-through" is required for charges. Previous DWP statements about when "look-through" is or is not required draw arbitrary distinctions between different investment structures, the application of which would be impractical and could lead to inconsistent results. By way of analogy, DC pension scheme providers do not "look-through" for charges which would count against the charges cap when investing in FTSE 100 financial services companies. It should be noted that a number of lawyers take the view that the legislation only requires charges at the level of the scheme investment to be counted against the charges cap and that "look-through" is not required by the legislation.

Question 1b: Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

The funds held by DC pension schemes are very large and are predicted to continue to increase significantly. The size of individual schemes varies, but as the DC market consolidates these funds will be held in a smaller number of larger pension schemes. We imagine that the investment of such funds (perhaps in tranches over a number of years) may be of interest to some private equity and venture capital managers. We understand that some private equity and venture capital managers may be willing to adjust their fee structures to attract such investment from DC schemes. However, requiring private equity and venture capital managers to materially change their fee structures would reduce the number of investment opportunities open to DC schemes. Allowing private equity and venture capital managers to continue to use performance-based fees in this context may encourage more such managers to seek investments from DC schemes. Furthermore, any change in fee structures may not be beneficial for investors. If performance fees were to be reduced or eliminated, that would be likely to result in an increase to fixed (non-performance related) fees. Any such change would decrease the alignment of interest between investor and fund manager that is implied by a "pay for performance" model.

Question 1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

The proposal outlined in this consultation may be part of the solution to the barriers posed by the regulatory charge cap. However other barriers should also be addressed including addressing the uncertainty created by previous DWP statements about "look-through" (please see the response above to Question 1a).

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

The main protection for members of the occupational DC pension is the decision-making of the trustees. Trustees are required to act in the best financial interests of members and to take appropriate advice to support their decisions.

It is important that, even if performance fees are excluded from the charges cap, there is transparency about such performance fees and the drag which they create on investment return so that the trustees can take this into account in their decision-making about such investments.

The charges cap is an important protection for members, but it can unfortunately lead to a focus on low charges rather than a broader consideration of what is in the best financial interests of members.

Question 2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

Private equity and venture capital funds typically include mechanisms to ensure that performance fees are not paid unless genuine realised outperformance is achieved.

The hurdle (which is customary for most types of private equity and venture capital fund) is a key component to ensure that performance fees only kick-in when genuine outperformance has been achieved. The hurdle is generally structured so that performance fees are not payable unless and until investors have actually received (i.e. on a realisation basis, not based on a fund's notional value) both their initial investment and a defined return on their investment. This should ensure that the performance fees are only paid when there is genuine realised outperformance.

In addition, funds generally include a deferral or escrow arrangement to ensure that performance fees are not paid early in the life of fund, even when successful realisations have been made, if it remains possible that performance will deteriorate later in the life of the fund to such an extent that performance fees have been overpaid based on the fund's total realised returns to investors. If and to the extent that such a deferral mechanism is not present, or if it does not fully prevent an overpayment of performance fees, there is generally a clawback mechanism to ensure that overpaid performance fees are returned to investors at the end of the life of the fund. This clawback obligation may be supported by personal guarantees in favour of the fund provided by the carry recipients.

These protections are negotiated by investors on a fund-specific basis and are, to some extent, dependent on the fund and its investment strategy. Therefore, while it could be a requirement for trustees to ensure that mechanisms to prevent overpayment of agreed performance fees are present, there may be merit in permitting some flexibility in the way in which such mechanisms operate so that trustees are not excluded from high performing funds because their hurdle and clawback mechanisms do not exactly match pre-defined rules.

Question 3: Which of these conditions should the Government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

There are two parts of this question. In relation to the conditions that should be excluded we do not have huge expertise, albeit the suggestions sound sensible - Carefully designed guidance (developed in consultation with experts in this area) may be useful – as is noted under Question 2 the main thing is that any structure is transparent. We agree with the point in 54 that schemes will be responsible for negotiating appropriate structures and levels of fees. It is interesting that this solution appears targeted at ‘own trust’ occupational pension schemes, when logically the focus should be on master trusts with scale to lead the way in developing new offerings. We note the comments around some master trusts being apprehensive on performance fees (31) but cannot see any reason why illiquid assets classes aren’t at least as relevant to these schemes (indeed they have been open in their desire to use them). Furthermore if master trusts do not use these arrangements it will be harder for other schemes to justify using them. This suggests work should be done with master trusts to identify workable solutions in this area.

This also leads into the second part of the question in relation to giving schemes confidence in relation to these assets. The implication is that guidance on structures will encourage schemes to use these assets, but this implies a target of medium size schemes whereas in practice only the largest and most sophisticated schemes will be interested in leading the way on this. Such schemes are likely to commit the resource to define their own conditions, and in doing so will break the ground for others to follow. Whilst guidance in this regard is useful it is just as important to allow sufficient freedom for schemes and fund managers to arrive at their own conclusions within this.

As is noted under Question 1a, with most schemes (particularly large ones) there is headroom under the charge cap, but they effectively work to a lower commercial cap. Therefore the charge cap itself is a bit of a red herring, but the argument for removing performance fees still stands in relation to this lower effective cap (which varies by scheme, but could be say 0.2% - 0.4%).

As a side point we note that exempting performance fees may present badly to members. Disclosing a very high fee payable to a fund manager looks poor, whereas if used within a wider investment strategy (say 15% of a default strategy) it may be that the impact is relatively small. Ultimately it should be up to schemes and investment managers to come up with the right solution for members that delivers value and communicate it transparently.

Further to a point made in the executive summary, we do have concerns about one particular performance fee methodology whereby the base AMC paid is zero – the '0:30' example, in regard to a level playing field with other asset class and investment approaches, particularly other alternative actively managed funds that are not illiquid. Not providing the ability for managers of liquid alternative active options from offering a similar fee structure could lead to trustees favouring one approach over another based on the ability of one to offer a fee structure whereby on a charge cap basis there are no implied fees. We would encourage some further consideration in this specific area.

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

We agree with the proposal to require disclosure of any fees outside of the charge cap. So much work has been done to improve transparency in terms of disclosing charges it would be a mistake not to continue this here. In addition these assets have a reputation for being opaque and favouring fund managers in terms of charges (as you note in point 31), removing disclosure requirements would create further negative perception.

Reporting in the same way as transaction costs makes sense, e.g. the Chair's Statement, but there are significant practical obstacles to effective transparency:

- The current Chair's Statement approach is acknowledged to be flawed and under review – any treatment of performance fees should fall within that wider root-and-branch review of the purpose and effectiveness of transparency.
- Members do not read the Chair's Statement.
- It is already hard for trustees to obtain the current raft of required information for Chair's Statements and asset managers are already not achieving that level of uniform disclosure. It is likely to be more difficult for illiquid investments.
- These matters are conceptually hard to explain in terms that members can easily grasp. As the onus is on the trustee(s) to make sure assets are generating value for members it may be worth ensuring there is a summary from this perspective to accompany any figures.

In terms of costs the main impact will be additional work for fund managers in terms of providing the required information and for trustees and their advisers sorting and presenting it.

Question 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

Yes; it would appear there would be no need for it.

Question 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

We believe the smoothing mechanism is too recent for the removal to have significant impact. We are not aware of schemes that have used it, but where they exist they are best placed to answer this.

Yours faithfully

Martin Willis
Chair, DC Committee, SPP

Fred Emden
Chief Executive, SPP

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