PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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Dear Incorporating performance fees within the charge cap team,

PLSA RESPONSE: INCORPORATING PERFORMANCE FEES WITHIN THE CHARGE CAP

The PLSA welcomes the intent to make it easier for DC schemes to invest in a wider range of assets, and illiquid investments. We are supporters of the current level of the charge cap, although we do recognise that it is a significant barrier to schemes being able to invest in private capital and growth equity. Variable fees, such as performance fees, do not interact well with a model that requires a guaranteed flat rate of charging projected into the future. Examples trustees have raised with the current approach include concerns about having enough headroom in the charge cap to accommodate any potential high-performance fees where assets have benefited from strong returns as this can cause a breach of the charge cap. We are also supportive of performance fees where they are currently charged for some management approaches, and when they are well-structured and aligned with member interests to encourage good outcomes for all parties. We welcome the Government looking at ways to facilitate schemes to invest.

Many schemes, in particular larger schemes, have an appetite for investing in illiquid assets and are already doing so. A small number of larger schemes are also looking at ways to incorporate private market illiquids into their defaults. The measures proposed here to amend the charge cap, so that performance fees can be smoothed over several years, will make it a little easier for schemes to invest in such assets. However, we do not believe that the alterations will lead to a material change in investment in illiquids as there are a number of other important reasons why schemes do not invest in them. In particular, a focus on low charges in a competitive market, the prudent person principle which requires schemes to take careful consideration of risk and reward and this is likely to always result in only a very low proportion of scheme investment in such assets and operational barriers, such as the flexibility to move pots when requested and daily dealing.

About us

We're the Pensions and Lifetime Savings Association; we bring together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with 20 million members and £1 trillion in assets, across master trusts and defined benefit, defined contribution, and local government schemes. Our members also include some 400 businesses which provide essential services and advice to UK pensions providers. Our mission is to help everyone to achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings, and to build the confidence and understanding of savers.

Background

In our response to the Improving Member Outcomes Consultation we supported the intent to deliver performance fee calculation over multi-year periods where that aligns with our wider desire to encourage and support the availability of more long-term investments, such as illiquid assets, to DC savers.

This is an area of Government interest and there has been several initiatives carried out in this area that the PLSA is involved in. For example, we are part of the Taskforce on Productive Finance, chaired jointly by John Glen MP, Nikhail Rathi, and Andrew Bailey that is looking at the barriers to long term investment by the pension industry.

However, there is a tension at the heart of the public policy between the desire to keep charges low for members, to consolidate the market, and the desire to help kick-start the post-COVID-19 economy by pension schemes investing in more varied investments such as illiquid infrastructure projects.

It is important that all government departments, representatives and regulators should be aligned, so as to avoid conflicting messages to schemes and therefore create disincentives. For example, the effect of VFM regulations has to date driven a focus on cost rather than outcomes and the Pensions Regulator's (TPR) recent consultation on the single Code of Practice proposing an upper limit (20% of assets) on private market investments, sends an opposing message and may further discourage trustees. On the other hand, the Financial Conduct Authority (FCA) has encouraged investment in illiquids by amending its permitted links rules to allow more flexibility in the choice of assets which can be invested in. More generally there have been concerns about the potential conflation of public policy and fiduciary duties and the importance of ensuring that schemes remain clear that investing in their member's best interests remains their fiduciary duty.

The consultation

Question 1: Are the performance fee regulations a) clear, b) likely to be taken up by trustees, c) going to make a difference to trustees' confidence to invest in illiquids?

The draft regulations for the new smoothed cap calculation are clear and we welcome that they are based on the current approach to ease the burden on schemes. The new calculation for performance fees under the charge cap could, in our view, make it easier for schemes to invest in venture capital and/or growth equity, if they wish to. It is likely to be helpful to smooth out periods of high performance (which will result in higher fees), although the charge cap would still be a barrier if the investment achieves consistently high performance. If there is a danger of breaching the charge cap trustees will not invest. Without complete certainty that the charge cap will not be breached in the future smoothing of performance will not go far enough in all cases. Some trustees may also be wary of using the new calculation due to complications around communicating charges to members in a simplified way and explaining why charges might vary over different years.

There are many other factors which negatively impact on trustees confidence in illiquid investment aside from the charge cap. For example, as discussed later, trustees tend to have a focus on low cost investments. Private markets are also generally more complicated investments, and require specialist advice and additional time in order for trustees to undertake these investments with appropriate due diligence.

Question 2: What is the likely appetite that pension scheme trustees have for investment in venture capital and/or growth equity?

The appetite for schemes to invest in these assets varies and depends on a number of factors, including the size of scheme. For example, we have seen some evidence of innovation from large master trusts[1], who are, or are aiming to, incorporate private market illiquids into their default funds by partnering with investment managers to create bespoke solutions in a cost effective and accessible way. However, smaller schemes may not have the same opportunities and therefore find it difficult to make or obtain the same kind of investments.

Larger schemes can and do offer illiquid investments[2] as part of their suite of investments to members, but outside of charged capped defaults (often in part due to the constraints listed in question 5) and where members can take an active choice to have a portion of their portfolio 'locked up' for longer or take higher risk for the potential of higher reward.

TPR guidance to trustees sets out the expectation that they follow the 'prudent person'[3] rule. Private market investments are generally harder to monitor compared to those traded on public exchanges, which makes it more challenging for trustees to undertake appropriate due diligence, and therefore can dissuade them from taking on these kinds of investments. These types of investment are generally more complex and sophisticated, requiring access to advice and resources that smaller schemes are less likely to have.

Question 3 How do you currently treat look-through when calculating the charges regime of the scheme?

Question 4 Does look-through act as a significant barrier to investment into investment vehicles that allocate to VC/GE?

Look-through can act as a barrier to investment into private capital and growth equity, however, other factors covered at question 5 are likely to be more significant. More generally there is no clear or consistent statutory basis, regulation or guidance for assessing look-through costs and practices are inconsistent depending on the type of investment. More clarity and certainty are needed, as a lack of clarity can create a disincentive to invest. For example, we would welcome further guidance and clarity on how trustees are expected to look-through to underlying costs in general, how far trustees should look-through in a given structure, how to obtain accurate and timely information about any relevant underlying costs and whether to incorporate such costs into the charge cap

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[1] Such as Nest and Smart.

[2] This tends to be via access to property and infrastructure funds and not directly in private equity/venture capital funds.

[3] TPR states that trustees have a duty to act prudently, meaning they 'must act in the way that a prudent person would in their own affairs'. https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/trustee-guidance

framework. In the absence of clear guidance, practices will vary across the industry as trustees assess the costs based on their own individual approach.

Question 5: Are there more significant barriers to the success of pooled illiquid investment vehicles than look-through? If so, what are they?

Look-through is not the most significant barrier to the success of pooled illiquid investment vehicles and to investment in illiquids more generally. One of the main barriers is the way in which scheme trustees put their primary focus on low cost investments.

We think it is important to recognise that schemes are typically charging below the charge cap - average PLSA member charges were previously found to be 0.46% - for a variety of reasons. Pension schemes value the headroom this affords them as it enables increased sophistication and innovation in their default investment strategies. In theory this headroom could be utilised to invest in illiquid or other alternative assets which typically carry a higher management fee. But perhaps more importantly, there is a structural issue that in a consolidating and competitive market, the focus of employers and savers is on lower fees for provision of services. The result is a market 'price point' at the levels currently seen. As a result, incorporating illiquids into mainstream commercial DC defaults that typically have an investment budget of 10-15bps (within the 0.4) is unachievable.

Higher charges will be uncompetitive and therefore would not be commercially viable. For example, we understand that having a 5% allocation to venture capital in a default fund could effectively double the total cost of the investment portfolio. For this reason, private equity costs are not affordable within the default, and from a scheme perspective appetite for this type of investment will also be tempered by the fact that higher costs, resource scaling-up and management will not guarantee higher returns. Any decision will also have to be balanced against competing, and likely easier to access investment options.

There are also operational barriers within DC schemes. Members in DC schemes have flexibility to move their pot to a different fund within the same provider, if other funds are available, and to other providers. Schemes need to be able to move these pots promptly. If the fund is invested in illiquid assets, larger schemes may be able to offset withdrawal requests by using contributions and their own cashflow to cover the otherwise prohibitively high costs of redemption – however, managing these offsets would require a high level of sophistication to ensure that members were treated fairly and schemes did not end up carrying any additional risks or costs.

Another operational barrier to schemes investing in these assets is that DC pension schemes and platforms often provide savers with daily valuation and dealing facilities, though they are not required to by law, models are designed with this expectation. Where funds are not daily traded there would be impacts on member quotes, as well as other areas, such as unit reconciliations. This can make incorporating illiquid assets into defaults harder, as many illiquid assets are not dealt daily.

Question 6: If perceived as a significant barrier, how can the Government act to ensure it is removed whilst maintaining member protection/the objectives of the charge cap? Should this change be a regulatory one or in guidance?

Question 7: Is there a risk of arbitrage? How can this be mitigated?

Question 8: Are there recognised industry definitions of venture capital and growth equity?

The government should continue to act to maintain member protection, through measures such as the charge cap. We believe removing the look-through requirement on certain investment structures risks arbitrage. In order to avoid unintended consequences and to achieve the policy intent it is important that barriers are addressed in order of their significance. There are more significant barriers than look-through, as outlined in question 5.

Removing the look-through requirement for pooled illiquid investment vehicles may be beneficial for schemes, by reducing some of the time and resource burden of the task. However, there are a number of risks, some of which are highlighted in the consultation. We agree, for example, with the identified risk that this approach may disadvantage direct investment compared to other investment vehicles, and that there is no industry-wide definition of venture capital. Members benefit from being as close to the underlying asset as possible, therefore direct investment should not be disincentivised. The proposed guidance on look-through of certain asset classes may incentivise the design of investment products purely to avoid the need to look-through, even where the economic value of product can be the same across multiple structures. Similarly, guidance on specific definitions, for venture capital and growth equity, may result in it excluding certain investment opportunities where it is unclear whether they meet a precise definition. Therefore, although there is no recognised industry definition, this is not necessarily problematic.

Removing look-through would also be inconsistent with general trends to increase cost transparency, and the evidence we have from the Cost Transparency Initiative is that schemes continue to seek greater clarity on some costs, and this is particularly true of larger schemes who would be expected to carry out this type of investment.

We would ask for greater clarity over current guidance and regulation (question 4) rather than changes to requirements. However, if changes are made, we believe it would be beneficial for them to be regulatory rather than in guidance. The potential for future changes in guidance would risk that schemes may no longer be compliant in the future, acting as a further disincentive to invest for the full term of the investment.

Question 9: Are there any other proposals that the Government should consider to allow greater investment in venture capital or growth equity?

Although it is clear that there are many challenges still to resolve, the PLSA has long supported measures that enable savers to benefit from risk/return profile that illiquid assets can deliver. We have and continue to be involved in government initiatives to remove the barriers preventing schemes from investing in illiquid assets with the intention of doing so for the long term. As part of the work in the Taskforce on Productive Finance, the PLSA is helping look at structural and perceived barriers to DC schemes investing in illiquid assets, such as trustee education. We are hopeful that the findings of this Taskforce will help to create proposals for resolving some of the potential barriers.

We hope that the above is helpful. If you would like any further clarification or information, please do not hesitate to get in touch.

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