PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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Dear Enabling Investment in Productive Finance team,

PLSA RESPONSE: CONSULTATION ON ENABLING INVESTMENT IN PRODUCTIVE FINANCE

The PLSA is pleased to have the opportunity to respond to this consultation. As members of the Productive Finance Working Group, we have welcomed the Government's efforts to explore potential barriers to investment into illiquid investments. As part of this group, we have committed to participating in the delivery of many of the recommendations and are committed to fostering an environment in which trustees of DC schemes have the infrastructure and support to make long term investment decisions.

Below we have set out our views on the issued raised. In summary:

- As we've set out in previous consultations, the PLSA does not believe the exclusion of performance fees from the DC charge cap will lead to an impactful change in investments in these asset classes. We believe that this proposal risks diluting an important protection for AE savers, without sufficient evidence, at this time, to demonstrate it will improve member returns.
- Given the various other developments in this area over the past year – including the introduction of a mechanism to 'smooth' the calculation of performance fees over 5 years, and the introduction of a new fund framework to help investors make long term investments – industry needs time to implement, develop and review effectiveness before making further changes.
- We note our support of Government and industry taking a long-term view to the barriers to long-term investment for DC schemes, and would like to see more consideration of existing operational barriers, the impact of an uncertain regulatory environment, and how the supply of appropriate products might be improved.
- All policy interventions should be made with long-term interests of pensions savers in mind.

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.

The consultation

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?

The PLSA is supportive of the Government's work to examine barriers (of which the charge cap is one) to pension schemes investing in a wider range of asset classes, including those considered 'illiquid' such as private equity and venture capital, and have supported a range of policy interventions to resolve these challenges. However, we believe that the situation is a complex one, with no single issue being identified as the main barrier. For this reason we would caution against the assumption that removing performance-based fees from the charge cap will significantly increase DC investments in assets like private equity and venture capital. A survey of our members[1] found that 28% would be likely to change their behaviour if performance fees were removed from charge cap, however, a larger proportion (36%) are not likely to change, and a further 36% would be neither likely nor unlikely to invest differently. Additionally, we do not expect to see a significant increase on the supply side of these assets, were performance fees to be removed from the charge cap.

Though we recognise that the charge cap in its current form may be resulting in cautious decisions being made by trustees keen not to breach it, we feel that the lack of evidence that the cap is a significant barrier to most – with average charges remaining significantly below the cap currently and many schemes finding ways to make significant allocations without breaching the cap- makes the case to remove it unconvincing, given that it will dilute a key protection put in place to auto-enrolled savers.

<u>Barriers to illiquid investment</u>

We outlined a number of barriers, aside from the charge cap, in our response to *Incorporating Performance Fees within the Charge Cap*[2]. In summary they were:

- *Cost* - Schemes' focus on cost (with many operating below the 75bps charge cap) due to the consolidating market and competition. This means that incorporating productive finance options with higher charges can make schemes uncompetitive and not commercially viable. The focus of employers and savers is on lower fees and there is competition even in non-default

[1] The survey ran from 15 December 2021 to 10 January 2022 and we received 40 responses.
[2] Performance fees within the charge cap: plsa response

funds to remain below the charge cap. Additionally, we note that several pension providers have, over the past year, indicated that they would no longer be willing to agree to the traditional performance fee model, but remained committed to having significant allocations to assets typically linked to this structure. We would therefore like there to be further consideration of the likelihood of the market evolving to better accommodate institutional investors and the needs of pension schemes keen to diversify their portfolios. 'Look-through' could also potentially act a barrier to these investments and, as stated in our previous response, we would welcome further guidance and clarity on how trustees are expected to take into account underlying costs when considering value.

- *Liquidity issues* – members in DC schemes have flexibility to move their pot to other funds within the same provider, and to other providers, and schemes need to be able to move these pots promptly. Some larger schemes offset requests by using contributions or their own cashflow to offset high costs of redemption. However, this requires a high level of sophistication to ensure that members are treated fairly and schemes do not carry additional risks or costs.

- *Operational* – DC pension schemes and platforms often provide savers with daily valuation and dealing facilities. Where funds are not daily traded (i.e. private equity and venture capital) there would be impacts on member quotes, as well as other areas, such as unit reconciliations. Though we appreciate that this is not a regulatory necessity, feedback from our members suggests that many platforms are not yet set up to accommodate investments compatible with a daily dealing and valuation model, and so this remains a significant operational challenge.

- *Sophistication* - Private markets are generally more complicated investments, and require specialist advice and additional time in order for trustees to undertake these investments with appropriate due diligence.

We would agree that many of these challenges are not insurmountable, and the PLSA is active in many forums seeking to find solutions that will better enable pension schemes to invest in a wider range of assets. In particular, we have been supporters and active members of the Productive Finance Working Group, and have made a number of commitments to take forward recommendations made by that group. We also welcome the recent joint Financial Conduct Authority (FCA) and The Pensions Regulator TPR) work on Value for Money, and strongly support the market moving away from a focus on cost alone.

Nevertheless, much of this work remains at an early stage, and we would caution against any assumption that removing performance fees from the charge cap will result in significant flows of capital towards these types of long-term investments.

Market context and concerns

Some larger schemes (e.g. Master Trusts[3]) are incorporating private market illiquids into their default funds. However, smaller schemes may not have the same access to scale and therefore find it difficult to make or obtain the same kind of investments. These asset classes are complex and we would suggest that only larger, more sophisticated schemes that have access to sufficient scale, and can take additional time to review these investments should be investing in these types of assets. Therefore, making changes to increase investment in these areas will impact a limited number of schemes, thereby limiting the amount of funds which may be available to invested. As the automatic enrolment market continues to mature, more schemes might seek to include these types of assets in their portfolio.

Similarly, some larger schemes can and do offer illiquid investments[4] as part of their suite of investments to members, but usually outside of charged capped defaults 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.

We would flag that some PLSA members have raised concerns that fund managers would start to push to include such charge mechanisms in other asset classes and that removing performance-based fees from the charge cap would set a precedent for removing other charges in the future. Though we appreciate that this is not being proposed at this time, we would urge caution in diluting an effective cost control mechanism without compelling evidence that it is in the interests of savers.

Fiduciary duty

Finally, we would like to note the strong belief of the PLSA, and the sector generally, that policy interventions that are focused on encouraging certain investment outcomes are at risk of breaching fiduciary duty. We firmly believe that the fiduciary duty of trustees should not be undermined or perceived to be undermined as part of this work, and we would encourage prioritising the needs of pension scheme savers, and the understanding that trustees should make investment decisions based on what they believe is most suitable for their membership. The suggestion in the question that trustees would make specific allocations as the result of a rule change does not take into account the various considerations that would have to be made in the event that trustees decided to invest in a new asset class in the interests of members.

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?

In general we are sceptical of this likelihood, but would welcome a discussion – through the Productive Finance Working Group – of how the providers of these products could evolve their fee

[3] Such as Nest and Smart Pensions

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

structures to accommodate the needs of pension schemes. We feel that there is a strong case that asset managers could have evolved their fees within the charge cap, and so at this stage we remain unconvinced that the effective removal of the cap for those working with some asset classes will result in a period of fee innovation in a way that has so far been lacking. As set out above, the fiduciary duty for schemes to act in the best interest of members, combined with the structural dynamics of the market, leaves us unconvinced that the proposed changes to the cap alone will result in significant capital flowing into these asset classes. We note the position several of the biggest Master Trusts have adopted over the past year in not paying performance fees. Though we recognise that this would not be viable for schemes lacking the same scale, we feel that there is a role for the investment management industry in considering whether their fee structures can evolve to accommodate the current charge cap rules.

As previously stated, we do not anticipate a significant increase in private equity and venture capital managers making products available to DC scheme investment.

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?

Over the past year there has been a great deal of activity in this area, most of which the PLSA has welcomed. In October a new rule came into place enabling performance fees to be 'smoothed' over a 5-year period. At the end of 2021, a new Long Term Asset Fund (LTAF) structure was established, with the support of the pensions industry. The Productive Finance Working Group has also published an initial set of recommendations, and is now focused on delivery. The FCA and TPR have also now commenced work to focus to Value for Money – again, something that is extremely welcome. We recognise that many of these proposals could potentially address what we view as clear barriers – particularly in relation to product availability – and we welcome the Government's commitment to putting them in place.

Nevertheless, we would prefer pension schemes to have the opportunity to explore the potential impact of these opportunities before further changes are made – the changes to performance fee calculations took effect on 1 October 2021, only shortly before the proposals to reverse them were announced, and at the time of writing, and, understandably given the short timeframe since their introduction, to the best of our knowledge there have been no LTAF's brought to market. At this point we cannot see the rationale in effectively abandoning this strategy untested. As participants on the Productive Finance Working Group, we are aware that delivery of the various recommendations are mostly at an early stage, and the group stopped short of making specific recommendations in relation to the charge cap. Therefore, we would suggest, initially, that the proposals set out in this consultation are not progressed, until we can better understand the impact of the initiatives already put in place.

In addition to this, we would like to see more work to understand the operational barriers schemes continue to face. For example, many of the platforms used are currently set up to enable daily dealing, and more frequent valuations of investments, than DC schemes require practically or by legislation. Anecdotally we've heard examples from our membership of requests for access to investments that don't fit into this model being refused. We realise that this is not necessarily an easy, nor quick, issue to resolve, and recognise the likelihood that there will need to be substantial investment by providers to evolve their systems. Nevertheless, it is a barrier that we feel is purely operational.

Some of the key problems associated with asset classes that use performance fees are generally not caused by legislation/regulation (e.g. liquidity issues) which limits the government's ability to remove barriers. Pension schemes will always be interested in investing in assets which have a strong likelihood of delivering higher returns over the long term, but these opportunities must be suitable for their members, transparent and provide value for money. We would question the focus that has been placed on pensions schemes adapting to accommodate performance fee charging structures, rather than on asset managers changing their charging structure to fit within DC schemes providing pensions to tens of millions of savers. Additional work to look at how asset managers could be encouraged to adapt their charging may be warranted.

Finally, we would like to see a cross Government effort to ensure that trustees have the reassurance of a consistent regulatory environment in order to make long term investment decisions. We are currently seeing a period of unprecedented change within pension regulations. Whilst we recognise that much of this is important, we are concerned that there is a tendency for some policy aims to appear contradictory. For example, in March, shortly after the Government commissioned the Productive Finance Working Group to make recommendations, TPR launched a consultation on a new Single Code that would prohibit schemes from holding more than 20% of their assets in unregulated investments. This had not been in line with how the existing code was interpreted or enforced, and it caused many of our members that hold illiquid investments significant anxiety. TPR since confirmed that it would not be progressing with that measure, which we very much welcomed. However, an environment in which policies are subject to frequent change – as is likely to be the case with the treatment of performance fees, and in which different bodies have misaligned policy aims - is one which is likely to promote a culture of caution among trustees. We note that the report of the Productive Finance Working Group stated that '*Uncertainty regarding how regulators and government agencies that oversee DC investment view less liquid investments was consistently raised by DC pension schemes as a barrier*'.[5]

[5] https://www.bankofengland.co.uk/-/media/boe/files/report/2021/roadmap-for-increasing-productive-finance-investment.pdf?la=en&hash=F92ADDFB1B815895AAFCC21CE6A29C5B0A74D6B7

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?

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?

Well-designed and well-structured performance fees can certainly offer investment opportunities which can be beneficial to members if they achieve improved returns from other fee structures. We do not believe that the charge cap is the place to control fees from asset managers.

However, we would raise a concern about how trustees should ensure that higher costs are applied fairly across their membership base. The presumption that higher costs will result in higher returns may be accurate across a scheme, but it is probable that it will impact members differently. In particular, those who are closer to retirement, or who may choose to exit the scheme, are at greater risk of paying higher fees than they would have done under the current arrangements, but enjoy no additional returns due to the long term nature of the investments. We would like to see this issue explored as part of the consideration of these proposals. We would flag that, even if the cap is adjusted trustees may still have reservations about fairness, and so may be reluctant to make use of it.

We take the view that it is the role of the FCA to ensure that all fee structure design is fair and in the interests of members – we do not believe that this is something that should be determined through the DWP's charge cap regulations. If the FCA takes the view that features of performance fees, like a problematic hurdle rate, are harmful, then they should be banned. We also recognise that the complexity of basing exemptions on specific asset classes, given definitional issues, and that it is likely to be difficult for these regulations to prescribe acceptable fee design, given the many variables and evolving market.

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?

As stated at Q2 and Q2a, we believe it is up to FCA to regulate structures of fees to ensure they are appropriate rather than through DWP guidance to schemes. If certain design elements are not considered appropriate it should be for the FCA to supervise and/or enforce against bad practices.

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.

In the event that these proposals progress, we would agree that there should be disclosure of performance fees outside of the charge cap and for this to be done in a similar way to transaction costs. It is crucial that costs outside the charge cap are properly and transparently disclosed to protect members. Doing so in a way that is consistent with transaction costs is reasonable.

We note that the recent DWP consultation on Climate Risk reporting proposed that performance fees, and what activity has taken place to achieve them, becomes a requirement in Implementation Statements. We hope that a consistent position will be found across the various reporting requirements, and that trustees are not asked to disclosure the same information in different formats to meet them.

Standardised disclosure of performance fees is important, just as the standardised disclosure of all fees is important to help investors to decide whether investments represent value for money. The PLSA, alongside the Investment Associate and the Local Government Association, have set up and support an industry standard for institutional investment cost data – the Cost Transparency Initiative[6]. We created a set of templates and tools which together form a framework that investors can use to receive standardised cost and charges information from asset managers. Along with the templates, which are open source and free to download, we also provide guidance for pension schemes and their advisers on how to make use of cost information, and for asset managers on how to provide cost information to their clients. Templates cover costs which draw down directly on the value of the funds of the asset owners, including direct and indirect costs. Performance fees are included within the templates, as are transaction costs, and further work could be carried out by the Cost Transparency Initiative to consider any new formats or changes to templates necessary as a result of any future changes to legislation regarding cost disclosure, aggregation or the charge cap.

[6] https://www.plsa.co.uk/Policy-and-Research/Investment/Cost-Transparency-Initiative

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?

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 more time should be given to the performance fee smoothing mechanism to assess its impact before removing performance fees from the charge cap. However, we would generally agree that the mechanism will have limited purpose in the event that performance fees are removed from the cap.

More generally, we would argue that more time should be given to let policies embed before reversing decisions – we believe that an ever-changing regulatory environment is likely to act as a disincentive to trustees keen to make secure, compliant, long term investment decisions.

However, it does make sense to remove the smoothing mechanism if performance fees are removed from the charge cap and current evidence suggests there would be no harm in removing without transitional arrangements.

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

Kate Boulden & Karen Hurst