THE INVESTMENT ASSOCIATION

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Dear Team,

RE: Investment Association Response to DWP consultation on 'Incorporating performance fees within the charge cap'

The Investment Association[1] (IA) welcomes the opportunity to respond to the DWP's consultation on incorporating performance fees within the charge cap. Investment is at the heart of DC pensions. Member outcomes are ultimately a function of the contributions paid in and the investment returns achieved on them. We therefore strongly emphasise the importance of ensuring that DC schemes can build investment portfolios capable of delivering the best outcomes for their members. This includes being able to access asset classes whose charging structures may be more challenging to fit within the current charge cap.

The specific proposals made in the consultation highlight the extent to which the charge cap is creating an environment in which absolute level of cost, rather than cost as measured against investment objectives and delivery, has become a determining factor. Piecemeal changes which then carve out specific asset classes or sub-classes or treat profit-share mechanisms such as performance fees in a complex manner, will only intensify the issue. The IA – like the Office of Fair Trading (OFT)[2] and the Pensions Regulator (TPR) – has

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[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. That is 13% of the £67 trillion global assets under management. The UK asset management industry is the largest in Europe and the second largest globally.
[2] Office of Fair Trading, *Defined Contribution workplace pension market study,* September 2013, p.26.

previously argued that a charge cap risks unintended outcomes, and the current consultation is a case in point[3].

Look-through

Look through should, in the first instance, be an issue of transparency. Trustees should have a full view of the charges paid by the scheme (which, in the case of underlying vehicles invested in by a fund, would manifest themselves as a drag on returns) in order to consider whether the charges paid are justified by the investment performance delivered.

Of course, the inclusion of the fees of underlying vehicles within the cap means their existence is more than simply a matter of transparency and understanding value for money. It does mean that there may be less headroom within the cap to accommodate these charges. Accordingly, schemes face a barrier to making allocations if they are constrained by the cap or (more likely) targeting a particular price point.

In that regard, removing the requirement to look through to the costs of closed-ended vehicles investing in Venture Capital (VC) or Growth Equity (GE) for charge cap purposes will make it easier for DC schemes to make such allocations. However, while this is helpful for these particular asset classes, it creates some serious level-paying field issues and highlights contradictions within the charge cap policy.

With respect to a level playing field, it immediately means that open-ended structures or closed-ended structures that invest in asset classes other than VC or GE are at a disadvantage as far as the charge cap is concerned. There is no rationale for doing this: pension schemes have a variety of structures to suit their needs and will have their own investment-driven reasons for selecting a particular structure (e.g., choosing an open-ended structure to accommodate regular inflows without creating premiums or discounts to the fund NAV). Choosing the structure based on what receives the most favourable treatment under the charge cap has nothing to do with the investment implementation decision and can distort those decisions.

The level playing field problem also arises with respect to different asset classes and management styles. VC and GE could have a role to play over time in DC portfolios, but no more so than public equities, private credit, real estate, or infrastructure, for example. Furthermore, paragraph 110 of the consultation highlights activities that are associated with the management of VC/GE investments which mean the management style is necessarily highly active in nature and therefore needs to be carved out of the cap for it to be viable in DC. This in itself is not a reason to privilege these asset classes: the same reasoning has not been applied to active security selection in public equities, asset allocation decisions in Multi-Asset Funds, or portfolios of real assets, for example, even though these activities also require active management. We see no rationale in investment theory for giving preferential treatment to particular asset classes and management styles.

[3] We have made a number of previous submissions on the charge cap, dating back to the original consultation on the policy in 2014. Our most recent submission was to the 2020 call for evidence on the cap and is available here.

It may skew scheme investment decisions and also gives a commercial advantage to managers offering strategies based on those asset classes. We do not believe regulation should be designed to benefit some firms at the expense of others.

There are practical challenges as well: how should VC/GE be defined for the purposes of exempting them from look-through requirements? What about a fund with a small VC allocation? Would a proportion of its fees be exempted from look-through? Would GE include listed smaller companies, which are an important part of the UK economic landscape? These kinds of perimeter issues are often hard to solve and introduce further complexity, all of which create further barriers to trustees making allocations.

This mixture of broad principles and operational complexities highlights the broader problem with the charge cap as far as investment is concerned: it makes innovation over time challenging and requires complex carve-outs to address particular challenges – as per the proposals in this consultation – which themselves create further unintended consequences of the type described above.

Rather than introducing further complexities and distortions piece-meal into DC scheme investment decision-making, we recommend that the purpose of the whole charge cap regime is re-considered in light of DC market conditions today[4], as well as with the future evolution of DC schemes' investment strategies in mind. This may also help schemes and managers deliver for pension savers in more innovative areas such as the Long-Term Asset Fund (LTAF) where, under the current proposals, some eligible assets might be carved out from the cap, but others not, creating even more complexity that will again work against the fundamental objective of ensuring capital is invested productively over the long term to the benefit of DC scheme members and other investors.

Performance fees

Performance fees are in essence a form of profit-sharing arrangement, which can strengthen the alignment of interests between investment managers and investors. Since they only arise where a manager has delivered outperformance for the investor, capping them simply disincentivises outperformance. This has no economic rationale.

Some DC schemes have expressed a desire to use them but have felt prevented from doing so by the cap, even though their use is not prohibited. Notwithstanding the consultation proposals to allow trustees to smooth performance fees, our view is that it is likely that they will remain infrequently used in DC. The method for assessing compliance remains complex and competes with other uses of trustees' limited governance time and resource. More fundamentally, the inclusion in the cap of profit-sharing arrangements in the form of performance fees is incompatible with providing trustees and pension providers with complete certainty that the scheme is compliant with the cap. This naturally makes

[4] We note that DWP's 2020 Pension Charges Survey showed that the average charge across all members of AE qualifying schemes was 48bps, well below the current cap. Charges below the cap have been a consistent feature of the market, as captured in previous DWP surveys. The charge cap seems to have been very effective in keeping charges low, but the issues raised in this consultation reflect the adverse impact this cost pressure has had on innovation.

trustees reluctant to use them, even if they would like to, which is another unintended consequence of the charge cap's existence.

A better approach would be to exclude profit sharing arrangements such as performance fees from the cap altogether and leave it to schemes to negotiate the appropriate arrangements with their investment managers. DC schemes are professional buyers of investment services and should be able to negotiate with service providers without having their hands tied by regulation. Appropriate member protection is provided by the fiduciary duty of trustees to members, the strong investment governance processes required by TPR and full transparency of costs and charges that trustees and their investment managers must comply with. Together these ensure that trustees must demonstrate why and how scheme investments are delivering value for money for members and this will include consideration of the charging structures used.

This may allow DC schemes greater possibilities in allocating to illiquid assets, for example through innovative fee structures that involve low base fees which are capped, alongside uncapped performance fees. Such a fee structure is likely to create a stronger incentive for a manager to deliver outperformance for the scheme, while being more flexible to suit DC schemes' investment budget.

Entry into force

We note the intention is that new rules will come into force in October, just three months after the publication of the outcome of both this, and the previous consultation on improving outcomes for members of DC schemes, which includes measures to bring the costs of closed ended funds into the scope of the charge cap. Whilst this short implementation window is appropriate for permissive proposals, such as in relation to performance fees, it is problematic where the perimeter of the charge cap is being adjusted. Redefining the scope of investment vehicles or asset classes that are within the scope of the charge cap may require schemes to change their asset allocation quickly, and at the same time, to ensure continued compliance. Given the adjustments concern assets at the more illiquid end of the spectrum this could cause acute forced selling pressure to the detriment of member outcomes.

I would be delighted to discuss these comments further if helpful.

Yours Sincerely,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market