Department
for Work &
Pensions

Investment Innovation and Future Consolidation:

A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution schemes

February 2019

Ministerial Foreword

Pension scheme trustees must always invest to deliver an appropriate return to their members. I am wholly committed to upholding that principle. But this very principle means that pension schemes ought to be thinking about the assets which help diversify and improve returns to beneficiaries. These same assets also drive new investment in important sectors of the economy – smaller and medium firms, housing, green energy projects and other infrastructure – which deliver the sustainable employment, communities and environments which all of us wish to enjoy.

I am therefore launching this consultation today to highlight the opportunities for defined contribution pension schemes to explore the full range of possibilities offered by investing for the long-term.

I have been really excited to work with HM Treasury and industry representatives on their work to support investment in early stage growth companies, referred to as Patient Capital. I believe the proposals being taken forward from this work will go a very long way to increase the supply of products – and in turn, create new demand for those products – which offer access to a broader range of investments.

Following on from the important work of the Patient Capital Review, I believe there is more we can do to stimulate trustees' appetite for a wider range of investment opportunities. That is why I am proposing that larger DC pension schemes should be required to set out their policy and current practice in relation to illiquid investments.

I am also bringing forward a proposal in this consultation which would encourage smaller DC schemes to actively consider consolidating into a bigger scheme. This will improve governance, and enable more pension schemes to reach the critical mass needed to access a broader range of investments, and nudge them to consider the benefits these investments offer.

Defined Contribution schemes are currently both smaller and less diversified than their Defined Benefit counterparts. With phasing of automatic enrolment contributions now almost complete, both master trusts and the largest corporate schemes are reaching a size where they can invest in less liquid assets – but only a small number so far do. All schemes now have clarity that they should take account of all long term financially material considerations – whatever their source – when deciding their investment strategy but this is not yet driving consideration of technological, social or environmental infrastructure. Consolidation is taking place, but it could be accelerated – we still have at least twenty times more schemes than Australia or the Netherlands.

It's remarkable that pension schemes from Australia, Canada and elsewhere have bought into UK infrastructure assets, but I rarely note similar investments by UK schemes. With the benefits of scale and the desire and capability to invest in a broader range of assets, I am confident that we can change that, and can begin to engage members more by showing how their contributions are being visibly put to work.

Finally I am bringing forward changes to accommodate performance fees – more often used for these investments – within the charge cap. We will not remove performance fees from the scope of the cap, or reduce protections for members. Most pension schemes charge well within the charge cap, and have ample opportunity to diversify beyond listed equities and bonds. I recognise, however, that the current methods of assessing charge cap compliance permit only the narrowest range of performance fees.

More broadly, this Government wants the UK economy to be amongst the most innovative in the world. We have set out a modern Industrial Strategy and made major new investments in infrastructure, innovation and new technologies. And we are committed to ensuring that the UK is a central hub for enterprise, innovation and creativity. I believe the proposals in this consultation can facilitate long-term investment by pension schemes both in the UK economy and elsewhere, by raising productivity, boosting economic growth, delivering good work and building stronger and more sustainable communities.

I look forward to hearing your views.

Guy Opperman MP
Minister for Pensions and Financial Inclusion

Introduction

This consultation brings forward three proposals to facilitate investment by Defined Contribution pension schemes in less liquid assets such as smaller and medium-sized unlisted firms, housing, green energy projects and other infrastructure.:

- Require larger DC pension schemes to document and publish their policy in relation to investment in illiquid assets, and report annually on their approximate percentage allocation to this kind of investment.
- Require some or all smaller DC pension schemes to conduct a triennial assessment of whether their members' may receive better value if the scheme consolidated into a larger scheme with more scale, and was wound-up.
- Offer an additional method of assessment for compliance with the charge cap, which applies in default funds of schemes used for automatic enrolment. More of those funds that offer illiquid assets charge a performance fee for outperformance against a benchmark.

About this consultation

Who this consultation is aimed at

- pension scheme trustees and managers;
- pension scheme members and beneficiaries;
- pension scheme service providers, other industry bodies and professionals;
- civil society organisations; and
- any other interested stakeholders

Purpose of the consultation

This consultation seeks views on policy proposals alone. Any regulations which we Government brings forward will be informed by responses to this consultation and other evidence.

Scope of consultation

Pensions policy is a reserved matter under the devolution settlement and, therefore, no devolved administration interests arise in relation to Great Britain. Northern Ireland makes their own legislation in relation to pensions.

Duration of the consultation

The consultation period begins on 5 February 2019 and runs until 1 April 2019. Please ensure your response to the draft regulations reaches us by that date as any replies received after that date may not be taken into account.

How to respond to this consultation

Please send your consultation responses to:

Sinead Donnelly and David Farrar
Department for Work and Pensions
Policy Group
Private Pensions and Arm's Length Bodies Directorate
Third Floor South
Quarry House
Leeds
LS2 7UA

Email: pensions.investment@dwp.gsi.gov.uk

Government response

We will aim to publish the government response to the consultation on GOV.UK.

Our response will summarise the responses to this consultation.

How we consult

Consultation principles

This consultation is being conducted in line with the revised Cabinet Office consultation principles published in January 2016. These principles give clear guidance to government departments on conducting consultations.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments about the consultation process (as opposed to comments about the issues which are the subject of the consultation), including if you feel that the consultation does not adhere to the values expressed in the consultation principles or that the process could be improved, please address them to:

DWP Consultation Coordinator
4th Floor
Caxton House
Tothill Street
London
SW1H 9NA

Email: caxtonhouse.legislation@dwp.gsi.gov.uk

Freedom of information

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact the Central Freedom of Information Team:
Email: freedom-of-information-request@dwp.gsi.gov.uk

The Central FoI team cannot advise on specific consultation exercises, only on Freedom of Information issues. Read more information about the Freedom of Information Act.

Chapter 1: Background

The illiquid investment opportunity

1. For several years, successive Governments have been keen to facilitate investment by UK institutional investors, particularly pension schemes, in less liquid investments, such as infrastructure[1].
2. Pension scheme trustees' primary focus must always be on delivering an appropriate risk-adjusted return to members. But by investing almost wholly in highly liquid investments such as publicly-listed equity and debt, beneficiaries can miss out on the illiquidity premium which results from being invested for the long term.
3. Both the UK and the global economy can also miss out. Where pension schemes only purchase public equity or debt on the secondary market, they are not driving new investment. Important sectors of the economy – smaller firms, housing, infrastructure and other green infrastructure – access less capital investment via public markets, and so do not benefit from the investment flows offered by pension schemes.
4. This is a particular concern in defined contribution (DC) schemes, where decisions which reduce long-term returns will affect member incomes in retirement.
5. There is also a recognised desire to improve engagement of members with the outcomes of their pension saving. Research suggests that people care about the impact that their money has on society and the environment[2]. Investment in the 'real economy' can give members an increased sense of ownership of their pension pot, and reduce the risk that they cut their pension contributions or withdraw from saving altogether.
6. Whilst some members can and do switch between funds and schemes, more than 95% of members of DC occupational schemes are invested in the default arrangement and are likely to remain invested there for many years[3]. This offers compelling opportunities to invest in long term, illiquid assets.
7. However, there have been some long-held beliefs about barriers to development of UK DC pension scheme investing, and a range of long-established investment

[1] By illiquid investments, in broad terms we mean assets which are traded off-exchange or are otherwise less readily tradeable. Examples include direct property investment, investment in infrastructure projects, private equity, equity or debt issued by very small listed firms, and venture capital. This definition also includes off-exchange or less readily traded impact investments which deliver comparable returns.

[2] Navigating ESG: a practical guide - https://www.dcif.co.uk/wp-content/uploads/2018/04/navigating-esg-final-lo-res.pdf

[3] DC Trust. Table 2.13 - https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-presentation-of-scheme-return-data-2018-2019

practices. Together these have acted as barriers to DC schemes investing in illiquid investments.

The Patient Capital Review

8. This consultation sits in the context of Government's wider work on patient capital. As part of the Patient Capital Review announced by the Prime Minister in November 2016, HM Treasury published a consultation 'Financing growth in innovative firms' in August 2017[4]. At Budget 2017 HM Treasury presented a consultation response and £20 billion action plan to finance growth in innovative firms over the next 10 years[5].

9. Two measures announced in the consultation response relating to pensions and supporting long term investment were:

   - A commitment by The Pensions Regulator to clarify guidance on how trustees can invest in assets with long-term investment horizons, such as venture capital, infrastructure, market-returning investments that have a social side benefit and other illiquid assets in a diverse portfolio. This guidance was published in October 2018[6].
   - The establishment of a Pensions Investment Taskforce, made up of institutional investors, fund managers, Government Departments and Regulators to unlock further supply of patient capital, including tackling continuing barriers holding back defined contribution pension savers from investing in illiquid assets.

10. Government updated on this work and further actions were announced at Budget 2018[7].

Regulatory barriers

11. Conclusions from HM Treasury's taskforce informed the 2018 Budget announcement on pensions investment and patient capital. This included three regulatory proposals.

   - An FCA consultation paper regarding proposed amendments to the permitted links rules for unit-linked funds. Consultation CP18/40[8] was published in December 2018. The proposed changes are intended to enable investors to

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[4] Financing growth in innovative firms: consultation - https://www.gov.uk/government/consultations/financing-growth-in-innovative-firms
[5] Financing growth in innovative firms: consultation response - https://www.gov.uk/government/consultations/financing-growth-in-innovative-firms
[6] Managing DC benefits: Investment governance, The Pensions Regulator, 2018 - http://www.thepensionsregulator.gov.uk/trustees/investment-management-in-your-dc-scheme.aspx
[7] Financing growth in innovative firms: one -year on https://www.gov.uk/government/publications/financing-growth-in-innovative-firms-one-year-on
[8] CP18/40: Consultation on proposed amendment of COBS 21.3 permitted links rules - https://www.fca.org.uk/publications/consultation-papers/cp18-40-consultation-proposed-amendment-cobs-213-permitted-links-rules

invest in a broader range of long-term assets, while continuing to maintain an appropriate level of protection. They are intended to benefit consumers and pension scheme members by allowing funds to choose investment opportunities that match the needs of consumers more effectively. The consultation period closes on 28 February 2019.

- An FCA Discussion Paper which explores how UK authorised funds can be used to invest in patient capital. Discussion paper DP18/10[9] was also published in December. It outlines the existing opportunities to invest in patient capital, and invites feedback to help identify any barriers to investment, and how these can be overcome. The FCA will consider responses and consult more widely with industry stakeholders to come to an informed view on whether any rule changes are necessary. Responses to this paper can also be submitted until 28 February 2019.
- A DWP consultation on a change to the method of assessing compliance with the DC automatic enrolment charge cap. This would make it easier for pension schemes to invest in funds with performance fees, often associated with illiquid assets. This consultation forms chapter 4 of this document. The change does not dilute or weaken the member protection - performance fees will remain wholly subject to the charge cap.

Non-regulatory barriers

12. The Pensions Investment Taskforce also found a range of non-regulatory barriers to pensions investment in patient capital and other illiquid assets. This included the difficulties associated with the daily pricing and dealing of illiquid assets; the high fees associated with venture and other forms of patient capital; and the need to identify investment options with an appropriate risk profile for DC.

13. To address some of these barriers, a number of large DC pension providers in the UK have committed to work with the British Business Bank to explore options for pooled investment in patient capital. This blueprint for pooled investment has the potential to provide spill-over effects to a range of illiquid assets.

14. DWP's continued focus on enabling safe and appropriate consolidation in both the DC and defined benefit (DB) pension sectors was noted as helping to provide greater scale for investment.

[9] DP18/10: Patient Capital and Authorised Funds - https://www.fca.org.uk/publications/discussion-papers/dp18-10-patient-capital-and-authorised-funds

Law Commission Review of Pension Funds and Social Investment

15. This consultation also sits in the context of the Law Commission's review of Pension Funds and Social Investment[10], which reported in June 2017 and made a number of similar recommendations.

16. The Law Commission recommended that Government should amend occupational pensions legislation to require trustees to state their policies in relation to long term financially material risks and their policy on stewardship. They also made similar recommendations to the FCA concerning the duties of Independent Governance Committees overseeing workplace personal pensions. Government and the FCA accepted these proposals. DWP has now legislated for occupational pensions schemes, and the FCA currently plan to bring forward rules for consultation in the first half of this year.

17. Recognising that many social impact investments are themselves illiquid, the Law Commission also set out a range of options for reform. It was suggested that the FCA should consider clarifying the permitted links rules, and that DWP should consider whether trustees of DC schemes should be required to regularly determine whether their members are disadvantaged in comparison to members of other schemes due to insufficient members or pooled assets. They also suggested that the DWP should continue to monitor the charge cap as pension schemes make more direct investments in innovative ways in physical assets.

Our objectives

18. The work carried out to date under the Patient Capital Review will help to both satisfy existing demand for illiquid assets more broadly, and also to stimulate latent demand.

19. Our engagement with larger DC pension schemes to date suggests that Government may also be able to take further action to increase the appetite for investment in illiquid assets, and to make it easier for schemes to invest.

20. Now that the number of large DC schemes is growing and consolidation is underway, the time is right to consider the question of whether schemes can and might be prompted to evolve their investment practices in certain respects. And, if so, what the right approach to encouraging this would be.

21. The next chapter sets out our appraisal of the current trends in scale and concentration of the defined contribution market. The chapter following that sets out initial proposals for approaches that could be used to prompt more trustees of large schemes to consider fully the opportunities provided by investment in illiquid assets, and invites further suggestions.

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[10] Pension Funds and Social Investment - https://www.lawcom.gov.uk/project/pension-funds-and-social-investment/

22. We are keen to look at and learn from experience in more mature DC markets overseas, and we will be reaching out to them as part of this exercise.

Scope

23. This consultation looks only at occupational DC schemes. It does not consider workplace or non-workplace personal DC pensions, where the market structure is quite different.

24. Neither does it cover occupational defined benefit (DB) schemes. Again the market structure in DB schemes is quite different – there has been a tradition of investment in illiquid assets, average scheme assets are more than £250m[11] and Government has recently announced proposals to facilitate DB consolidation into superfunds.

25. The Pensions Infrastructure Platform already provides a pipeline of illiquid investments to DB pension schemes. In addition, the demand amongst DB schemes for some illiquid investments, especially those with a higher risk-return profile, may well have peaked as an increasing number target buyout in the short to medium term.

26. As this is a consultation on policy proposals only, and a wide range of policy options are presented, an impact assessment has not been produced at this stage. An impact assessment will be produced for any draft legislation which is brought forward for consultation.

[11] The Purple Book: DB pensions universe risk profile - https://www.ppf.co.uk/sites/default/files/file-2018-12/the_purple_book_web_dec_18.pdf - figure 2.1 and 2.2

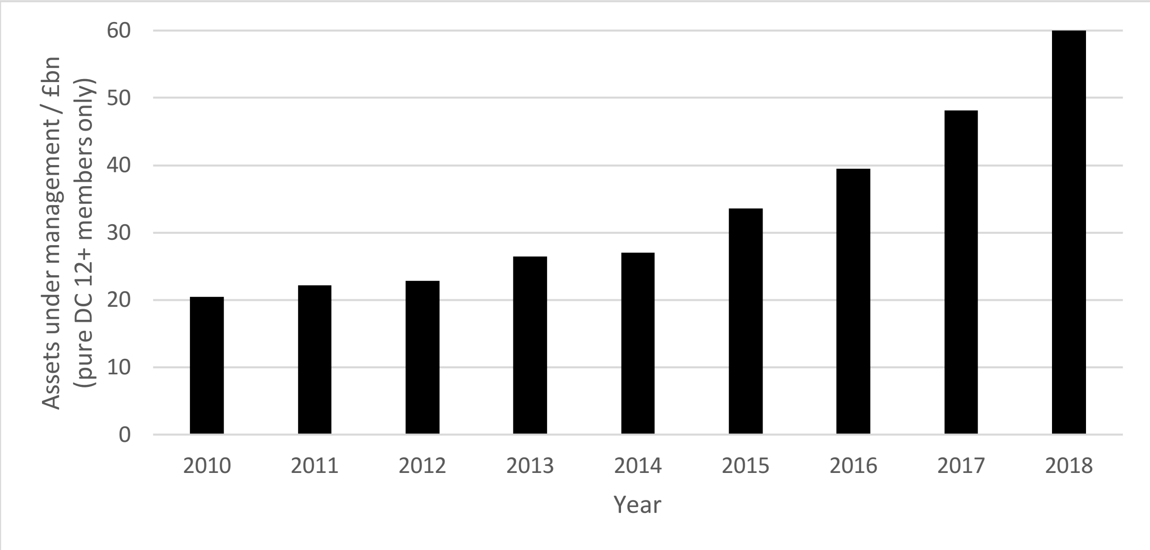
Chapter 2: The changing occupational DC environment

The occupational DC investment landscape

1. Whilst assets in occupational DC schemes are currently much lower than in more established DB schemes, the Government's introduction of automatic enrolment (AE) and the development of master trusts as the most popular savings vehicle, is leading to rapid and accelerating growth.

2. Assets in occupational DC schemes have more than doubled in the 4 years to 2018, and are likely to accelerate with the second round of phasing in April 2019.

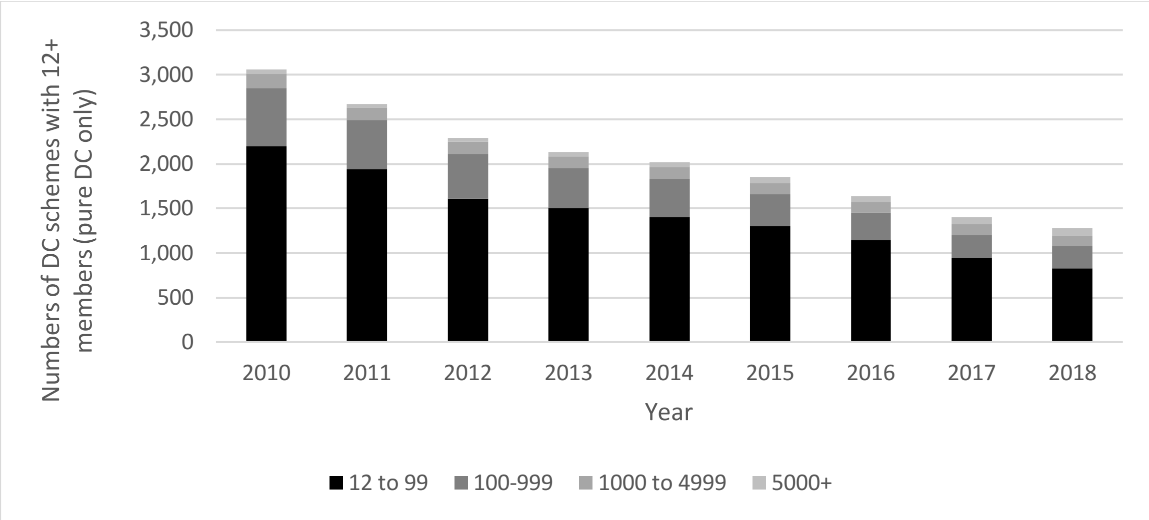
Figure 1: Total occupational pure DC[12] scheme assets by year[13]



3. As DC saving has expanded, DC schemes have also consolidated significantly over the same timescale. The decline in scheme number has largely been driven by the result of closure or consolidation of smaller schemes. Numbers of pure DC schemes have almost halved.

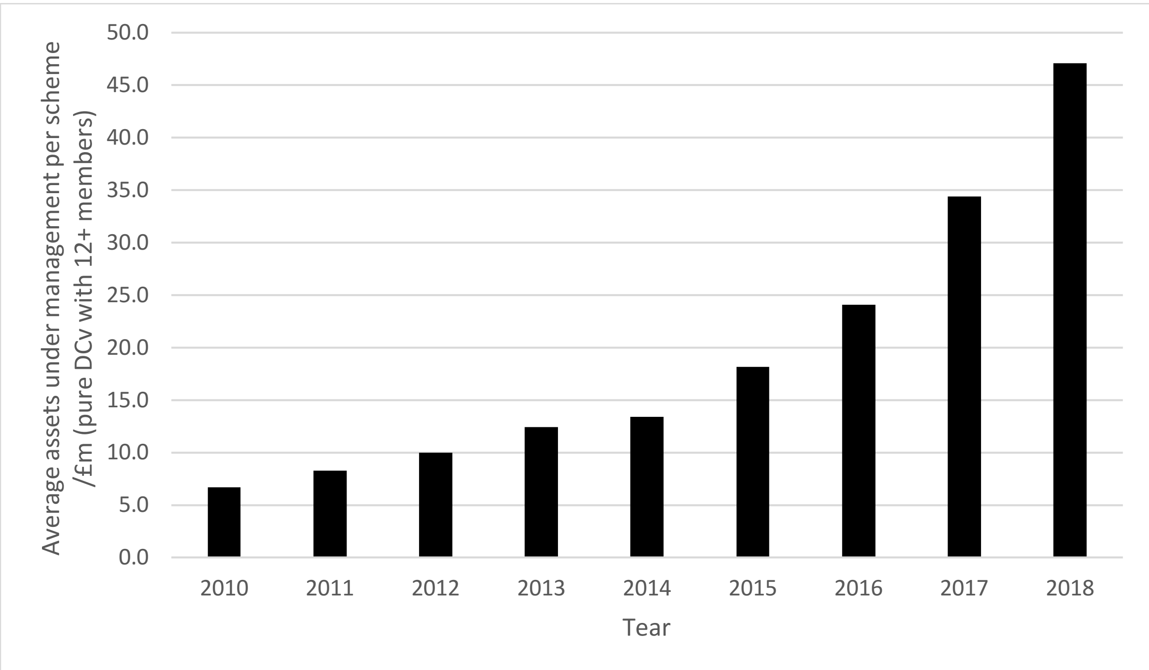
[12] By 'pure DC' this consultation means pension schemes in which all the benefits are defined contribution. It therefore excludes assets and members invested in the DC sections of hybrid 'dual section' pension schemes.
[13] DC Trust - Table 3.1 - https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-presentation-of-scheme-return-data-2018-2019.

Figure 2: Occupational pure DC scheme numbers by year[14]



4. Nevertheless, the DC market remains quite fragmented compared with international markets. Australia and the Netherlands each have only around 200 pension schemes in total, albeit with smaller populations.
5. Average DC scheme assets have increased over time but also remain low, at around £47m[15]. However, as assets increase and if consolidation continues, there is clear potential for the nature of the UK DC market to evolve.

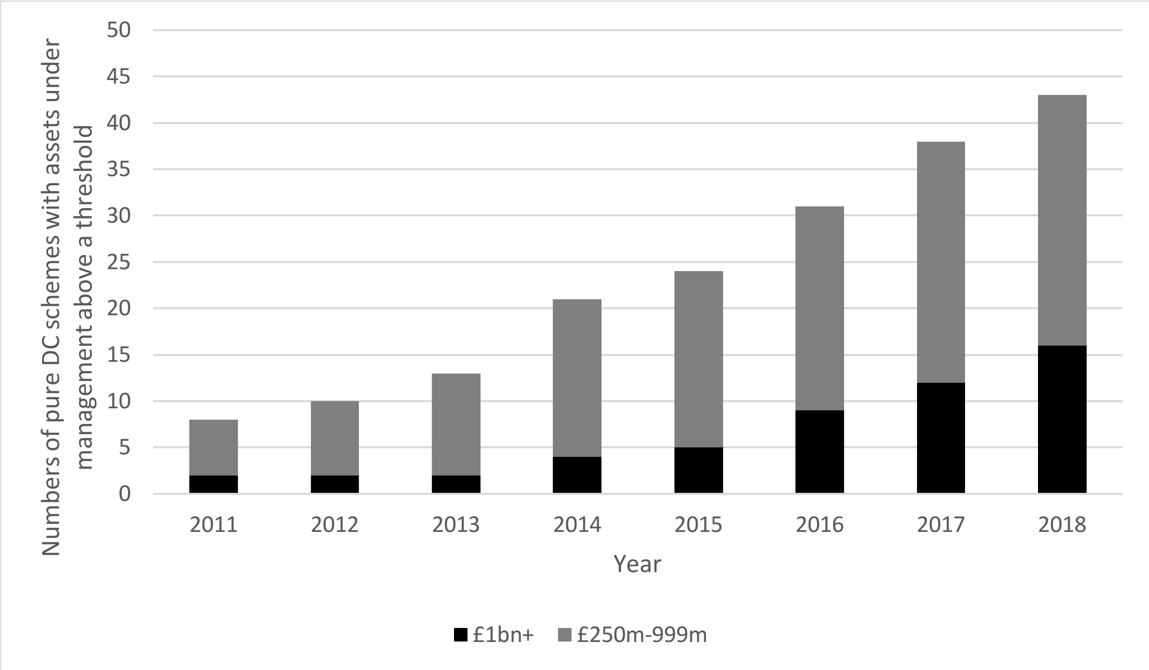
Figure 3: Average assets of occupational pure DC scheme by year[16]



[14] DC Trust Table 1.18
[15] DC Trust - Table 1.18 and table 3.1
[16] Ibid.

6. The number of large DC schemes is increasing over time, but from a low base. This Consultation seeks views on whether more action should be taken to accelerate this.

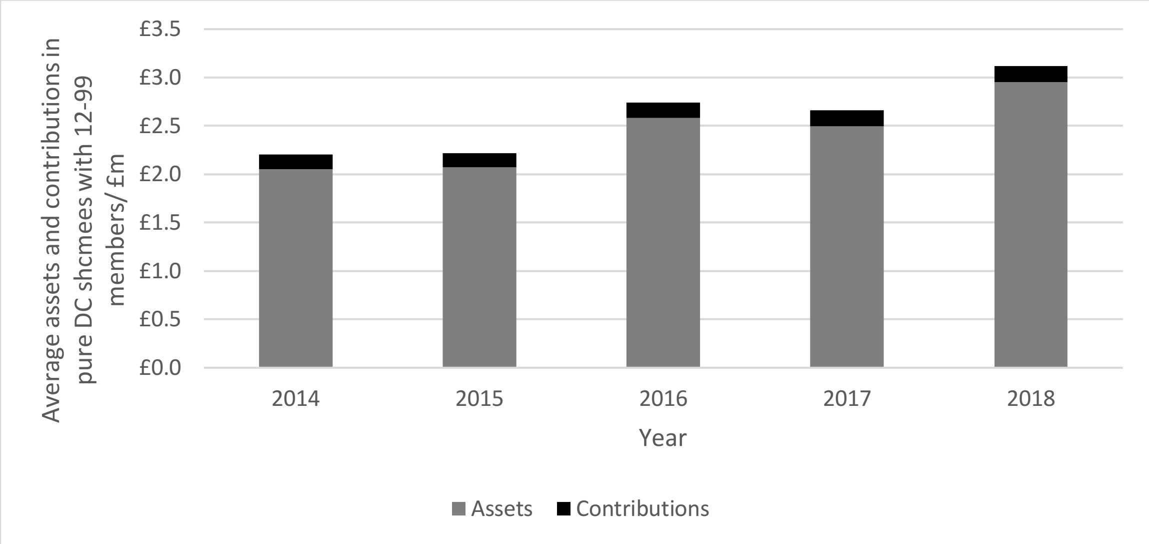
Figure 4: Number of very large occupational pure DC schemes by year[17]



7. Whilst figure 2 above shows that numbers of small and medium pension schemes have fallen fastest, there are still many schemes, with low memberships and very low volumes of assets. Figure 5 shows that the average assets of the smaller pension schemes are increasing slightly over time. However they are not keeping pace with those in pension schemes as a whole, as comparison with figure 3 shows.

[17] DC Trust Table 1.17 – with additional data provided by The Pensions Regulator, based on scheme return responses

Figure 5: Small pure DC schemes by year – assets and contributions[18]



8. Average assets in the 1080 pure DC schemes with 12-999 members are less than £3m. The Pensions Regulator does not collect asset data on the approximately 1700 schemes[19] with 2 to 11 members but these will typically be much lower still.

9. Schemes with 12-999 members are receiving average contributions of around £160,000 each year[20], and are only being used for automatic enrolment in relation to 357,000 members[21], out of a population of 10 million.

The DC environment for illiquid investments

How DC schemes invest

10. Most DC schemes currently invest via insurance platforms, purchasing unit-linked long-term contracts of insurance which mirror the returns of underlying investments. We anticipate that the FCA's proposed changes to permitted links rules, referred to in chapter 1, will facilitate more investment products blending liquid and illiquid assets to come to the market.

11. Over the long term, as the largest DC schemes reach the scale of large Defined Benefit schemes, they may move off insurance platforms altogether, and hold, tailor, blend and unitise both liquid and illiquid assets directly. This will also

[18] DC Trust - table 1.18, 3.1 and 3.3
[19] TPR estimate based on numbers of Small self-administered schemes and estimated numbers of Executive pension schemes – see footnotes 27 and 28 for definitions.
[20] Table 1.18 and 3.3, DC Trust
[21] Table 4.1 and 4.4, DC Trust

increase their ability to carry out stewardship of the assets and engagement on their own behalf[22].

12. There is currently a lack of definitive publicly available information on the level of investment in illiquid assets by occupational DC. Despite the accepted advantages of diversification and securing the illiquidity risk premium, it is widely known that allocations are low. Whilst many DC schemes invest small amounts in commercial property, illiquid asset classes are generally only found in very low volumes in DC default funds.

13. Other things being equal, pension scheme trustees are likely to wish to diversify across a wide range of investments, However, we believe that there may be a lack of current appetite and motivation on the one hand, and a lack of scale (and associated factors such as expertise and governance capacity) on the other.

14. Whilst we occasionally hear the suggestion that the DC automatic enrolment charge cap may be a barrier, evidence suggests that this is not the case, except for the smallest pension schemes. DWP's 2016 Pension Charges Survey[23] found that the average charge was between 0.38 and 0.54% of funds under management annually, well within the 0.75% charge cap.

15. It has also been suggested that the requirement for pension scheme assets to "consist predominantly of investments admitted to trading on regulated markets", and for other investments to "be kept to a prudent level"[24] represents a hindrance. But regulated market is broadly defined[25], it is already possible to get access to illiquids via regulated markets, and the requirements for prudence do not prevent an allocation which is significantly above current levels.

Trustee appetite

16. The factors that influence how pension scheme trustees approach their fiduciary duty to their members will vary, for example depending on scheme type. DB schemes trustees are motivated to manage the scheme's funding position alongside securing the members' benefits. In contrast, the trustees of DC schemes are not necessarily prompted to consider the benefits of alternative asset classes as long as they consider the net risk-adjusted returns of the existing asset mix to be appropriate.

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[22] By pooling assets, Collective Defined Contribution schemes may also be able to do this sooner. This will create the opportunity for such schemes to take a more active role in selecting, negotiating and investing in illiquid assets.

[23] https://www.gov.uk/government/publications/pension-charges-survey-2016-charges-in-defined-contribution-pension-schemes

[24] Regulation 4(5) and (6) of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378).

[25] a regulated market within the terms of Council Directive 93/22/EEC on investment services in the securities field; or a regulated market within the terms of the MIFID II directive; or any other market which operates regularly, is recognised by the relevant regulatory authorities, and in respect of which there are adequate arrangements for unimpeded transmission of income and capital to or to the order of investors, and adequate custody arrangements can be provided for investments when they are dealt in on that market.

17. In 2013, the then Office of Fair Trading found that the ‘principal-agent problem’ applied particularly strongly in defined contribution schemes. The employer acts as an ‘agent’ in choosing a pension scheme on behalf of the principal (their employees) but does not have an intrinsic long-term interest in scheme outcomes.

18. Many employers take selection and oversight of a pension scheme very seriously – however, the key driver for some will be that the scheme qualifies for automatic enrolment. A range of competing factors may influence scheme selection. There are particular barriers to taking account of the benefits from appropriately diversified and illiquid investments, as these will necessarily be technically complex and more resource intensive to evaluate.

Pension scheme scale

19. Currently, the high minimum investment associated with illiquid investments can mean that many DC schemes may not have sufficient overall assets under management to allocate safely a percentage to a particular illiquid investment without over-concentrating their portfolio.

20. Similarly, the complexity and one-off nature of many current illiquid investment opportunities necessitates increased due diligence and specialist knowledge. Smaller DC schemes will not have this in house and may struggle to buy it in cost-efficiently.

21. Smaller schemes also tend to levy charges on members which are closer to the cap – the 2016 charges survey showed that average charges in schemes with 5 or fewer members were typically 0.72%[26] - so this is another barrier to small scheme investment.

22. Issues with small and sub-scale schemes are of course not confined to charges or access to investments alone. The Pensions Regulator has found a significant correlation between the effectiveness of pension scheme governance and scale. In 2018 they examined compliance by single-employer occupational pension schemes (excluding Small Self-Administered Schemes[27] and Executive Pension Schemes[28]) with 4 Key Governance Requirements[29].

    - Trustee boards must possess or have access to the knowledge and competencies necessary to properly run the scheme
    - Trustee boards must assess the extent to which charges/transaction costs provide good value for members
    - Core scheme financial transactions must be processed promptly and accurately

[26] *Ibid.*
[27] Small self-administered schemes must have 11 or fewer members, who are all trustees or directors of a corporate trustee; decisions must be made unanimously or by an independent trustee.
[28] Executive pension schemes are schemes in which an employer is the sole trustee, and the members are all current or former directors, of whom at least one-third are current directors.
[29] DC trust-based pension schemes research: summary report 2018 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis

- Trustee boards must ensure the default investment strategy is suitably designed for their members (applicable only to schemes with a default investment strategy)

23. The Regulator found many instances of weaker governance in smaller schemes – 80% of schemes with fewer than 100 members complied with only 1 or none of these key requirements; for schemes with 100 to 999 members this figure was still 40%. In contrast only 15% of single employer schemes with 1000+ members complied with 1 or no key governance requirements.

24. Strong governance was also found rarely in small schemes. Compliance with all the key governance requirements was found in 1% of schemes with fewer than 100 members, and only 13% of schemes with 100 to 999 members, in contrast to 28% of large schemes.

25. These results also do not improve significantly on those collected since The Pensions Regulator began to monitor compliance with the Key Governance Requirements in 2016[30]. This finding is also supported by The Pensions Regulator's Trustee Landscape Qualitative Research in 2015[31] and 2016[32] Informed by further evidence from its value for members thematic review[33] The Regulator has consequently begun to take action to encourage smaller schemes to consolidate.

[30] See DC trust-based pension schemes research: summary report 2017 and 2016 - https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis

[31] Trustee Landscape Quantitative Research: A report on the 2015 Trustee Landscape –research https://webarchive.nationalarchives.gov.uk/20160701133407/http://www.thepensionsregulator.gov.uk/docs/trustee-landscape-quantitative-research-2015.pdf

[32] Trustee Landscape Qualitative Research: Further investigations into board dynamics and trustee training - https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis

[33] Value for members thematic review - https://www.thepensionsregulator.gov.uk/en/about-us/how-we-regulate-and-enforce/thematic-reviews

Chapter 3: Further measures to facilitate investment into illiquid investments

Reporting on the scheme investment approach

Using transparency as a prompt

1. Many recent Government measures in pensions, as elsewhere, have sought through transparency measures to offer a prompt to take account of important matters.

   - Publication of costs and charges and the trustees' assessment of the value for members they offer are intended to prompt pension schemes to consider whether they can justify the charges they impose on their beneficiaries in comparison with other trusts, and take ameliorative action where they do not.
   - Publication of the Statement of Investment Principles (SIP) prompts trustees to ensure that it reflects the scheme's own investment beliefs and practices, rather than a generic or 'boilerplate' document.
   - Publication of the Implementation Statement, showing how the trustees followed the Statement of Investment Principles, acts as a further prompt to making the SIP a statement of specific and measurable principles which are acted on in practice.

2. By opening up pension schemes' strategies and investments, transparency measures also offer the potential to foster increased engagement by members with their pension savings.

3. We therefore would welcome views from respondents on whether a similar requirement for a statement of the extent to which trustees have considered illiquid investments in their investment strategies could act as a prompt for trustees to consider the opportunities for further investment innovation in their defaults.

Trustee primacy in investment decisions

4. Government acknowledges that trustees have primacy in investment decisions.

5. However, a possible requirement to explain the consideration of illiquid assets is wholly compatible with that principle. There would be no requirement to invest in any particular way. The proposed approach would seek to prompt schemes to document their consideration of a range of asset classes which might deliver sustainable and competitive long-term returns – something which would typically fall into scope of trustees' fiduciary duties.

Scope of the measure

6. As we recognise that a wide range of illiquid assets will not necessarily be available to smaller DC occupational schemes, we believe a reporting requirement may be disproportionate below a certain threshold.

7. We therefore suggest that this might apply to DC schemes with assets above a certain level, perhaps £250m or £1bn.

8. Alternatively, given that asset levels in DC schemes will fluctuate, causing schemes to drift in and out of scope, we might instead use scheme membership as a more stable threshold – perhaps 5,000 or 20,000 or more members, including active, deferred and pensioner members. Such an alternative would, however, be an imprecise proxy. It would inevitably capture a few master trusts whose low assets meant investment in illiquid assets was currently impractical (though likely in future), whilst missing some more mature schemes with lower memberships for whom it would be much more feasible

9. Our understanding is that schemes with DB and DC sections typically manage the assets of these sections of the scheme quite separately - for example, investing via segregated mandates and unit-linked long-term contracts of insurance respectively. It may well be reasonable to extend this requirement to also apply to any non-money purchase schemes with 5000 (or 20,000) or more members with money purchase benefits, or with assets of £250m (or £1bn) or more to pay those benefits.

10. As with other governance and publication measures, we would propose that schemes whose only money purchase benefits are the result of Additional Voluntary Contributions would be out of scope of this measure, as would other schemes which fall outside of the definition of 'relevant schemes' in the Occupational Pensions Schemes (Investment) Regulations.

11. At present there are approximately 140 schemes with 5000 or more members[34], and our estimate is that there are only around 60 schemes with £250m or more in assets[35]. Whichever approach is used, the regulatory impact of this measure would tend to be limited to schemes which already have in-house investment experts or access to suitable external advisors.

12. In time, we would expect to see the number of large DC schemes grow. This is being driven by a number of factors including the growth of member numbers and assets as a result of automatic enrolment into workplace pensions and increasing consolidation in the market, driven by the introduction of master trust

[34] Table 1.2 - https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-2018

[35] This estimate is based on a comparison of the memberships of DC schemes, including hybrids, with average DC assets per scheme member. It differs slightly from the data shown in figure 4 as it includes the DC sections of dual section schemes, as well as pure DC schemes, in which all the benefits are money purchase.

authorisation and changes to improve the scope for DC to DC bulk transfers[36]. We would therefore expect an increasing number of schemes to come into scope of the proposed approach over the coming years, although this may well level off if consolidation into a relatively small number of master trusts continues.

Including illiquid investment information in the Statement of Investment Principles

13. Our initial proposal is that schemes in scope could be required to state their policy in relation to illiquid assets in the Statement of Investment Principles (SIP), and potentially in the Default SIP. Such a measure appears to provide a good fit with other existing or forthcoming requirements such as schemes' policies in relation to the kinds of investments to be held, and the balance between them.

14. Schemes in scope would then report annually via the Implementation Statement on how they had followed their policy on illiquid assets. The Implementation Statement and the Statement of Investment Principles are already required to be published online, in a phased approach beginning in October 2019.

15. In relation to illiquid investments, we want to avoid statements being general or generic. Consequently, we would look to require that the Implementation Statement contains quantitative data. Including numeric data will allow trustees, members and others to compare allocations and allow for greater understanding (and possible remedial action) about any barriers to illiquid assets in certain types of scheme.

16. Data in the implementation statement could also be required to be provided with a greater or lesser degree of granularity. For example, schemes could also be required to report levels of illiquid debt and illiquid equity. Alternatively, sector breakdowns might be required, such as between early stage unlisted firms, infrastructure investment and so on.

17. We recognise that in order to quote an overall percentage we would need to define illiquid investments reliably. In chapter 1 we defined illiquid assets as those which are traded off-exchange or are otherwise less readily tradeable. Assets will of course become more or less tradeable depending on market conditions. A percentage of off-exchange assets alone would under-estimate pension schemes' overall holding, so it may be appropriate to offer a broad definition in regulations and allow schemes some flexibility in interpretation.

18. We also recognise that schemes will generally not be able to quote exact holdings, because they are also investing in pooled funds which have a changing pattern of holdings – for example, they may be invested in diversified growth funds which include holdings in listed infrastructure, rarely traded bonds, private

[36] Simplifying the process for defined contribution pension scheme consolidation whilst maintaining member protections - https://www.gov.uk/government/consultations/bulk-transfers-of-defined-contribution-pensions-without-member-consent-draft-regulations

debt, or property. This complexity in making accurate estimates would increase if further breakdowns were required.

19. Taking these considerations into account, we propose overall that relevant schemes' annual Implementation Statement would be required to include their default funds' approximate percentage holdings in illiquid assets, broken down by the trustees of the scheme, but that schemes have flexibility in both the level and categorisation of this breakdown.

Q1.

We would welcome comments on the following proposals around reporting pension schemes' approach to investing in illiquid assets. We would also welcome any other proposals which use reporting to prompt consideration of illiquid assets.

(a) <u>Scope:</u> 'Relevant schemes' (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 or 20,000 or more members (or alternatively £250m or £1bn assets to provide for money purchase benefits) would be in scope of the proposed requirement. Would an asset-based or a membership-based threshold be more proportionate and effective?

(b) <u>Reporting their policy:</u> Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles

(c) <u>Reporting their actions</u>: Schemes in scope would be required to report annually on their main default arrangements' approximate percentage holdings in illiquid assets, and with a breakdown in holdings of the trustees' choosing.

Encouraging consolidation

20. As highlighted earlier, DC schemes in the UK are considerably less consolidated than in some other jurisdictions, and this can limit their ability to deliver an appropriate risk-adjusted return by stymying access to the potential benefits offered by less liquid investments. Of more immediate importance, as highlighted earlier, there is significant evidence that smaller DC schemes are not as well governed as large schemes and master trusts, increasing the risk of poorer outcomes for members.

21. Numbers of schemes have fallen historically, and measures to simplify DC consolidation and to require authorisation of master trusts are expected to maintain the current increased pace of consolidation.

22. However, pension scheme trustees can exhibit inertia in the same way as pension scheme members. They may persist in running a scheme because the barriers to exiting – whether those stem from a lack of knowledge, time or awareness – appear to be high. Evidence suggests that a long tail of smaller schemes is likely to remain without further regulatory intervention.

23. There is therefore potential to explore options to accelerate the consolidation process further. Increased scale would spread the costs of improved governance across a broader base of assets, and carries the potential to broaden the range of investments. We would welcome views on how further consolidation might best be achieved. Some initial proposals are highlighted in the next section.

24. We acknowledge that smaller schemes will have service providers who have considerably more scale. Schemes may be serviced directly or indirectly by large investment consultants, insurers, fiduciary managers or asset managers who are able to access significant scale.

25. However, trustees have ultimate responsibility for members' assets, not their service providers. Small schemes will generally be less able to enter more innovative or less liquid investments due to the more limited governance or oversight which small schemes are able to offer, and the extent of other costs which result from a lack of scale, in particular the higher cost of administration. Research has also suggested persistently weaker governance and oversight in the smallest schemes.

Q2. Do you think Government should encourage or nudge smaller occupational DC pension schemes to consolidate? If this should only happen at some point in the future what factors should be taken into account in determining that point?

Extending the Chair's Statement to cover consolidation

26. One option would be to extend the 'value for members' assessment, which schemes are already required to produce as part of their Chair's Statement. This could include an assessment of whether it might be in the scheme members' interests to be transferred into another scheme, such as an authorised master trust.

27. Such an assessment would need to be holistic. Whilst pension scheme charges and costs and the strength of the default investment strategy would be significant considerations, they would not, on their own, form the whole of such an assessment. Other concerns such as the quality of governance or administration would also be legitimate areas of comparison. Wider factors are also likely to be relevant – whether the scheme is open or closed, the demographic profile of the membership, the range of decumulation options and any strongly held views of the membership about the desirability of retaining their own scheme. It may be necessary to issue statutory or non-statutory guidance about how such an assessment should be carried out by trustees.

28. The requirement to publish the assessment of whether it might be in members' interests to move to another scheme, as part of the value for members assessment, could again serve a useful purpose in nudging trustees to consider consolidation more actively than previously.

29. We recognise that there is a risk that schemes with disengaged trustees might not seriously evaluate the potential benefit of consolidation. It is therefore possible that active supervision and application of a penalty regime may be necessary for the policy to have the desired effect.

30. There is also a certain threshold of scheme above which it may be disproportionate to require schemes to produce or publish such an assessment. This might be set at £10m in assets or 1,000 members initially. Setting the threshold at 1,000 members includes up to 2,800 pure DC schemes which collectively account for approximately 7% of assets[37], but excludes the largest 200 pure DC schemes, which account for the remaining 93% of DC assets.[38]

31. It is likely to be disproportionate to require relevant schemes to carry out such an assessment every year given the likely rate of change within schemes. Doing so might also result in more surface-level or perfunctory assessments. We therefore propose that schemes in scope should be required to produce an assessment of whether it might be in members' interests to consolidate at least every 3 years, and after any significant change in size or demographic profile of relevant members – for example, if the scheme transferred out the majority of its members, or the vast majority of its older members due to a corporate transaction.

Q3.

We would welcome views on the following proposals around pension schemes reporting their position on the potential benefits of future consolidation, or any other associated proposals.

(a) <u>Scope:</u> 'Relevant schemes' with fewer than 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.

(b) <u>What should be reported:</u> Schemes in scope could be required to explain their assessment of whether it would be in members' interests to be transferred into another scheme with significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?

[37] DC Trust. Table 1.18, 3.1 and 5.4, combined with TPR estimates of Executive pension scheme numbers.
[38] DC Trust. Table 1.18 and 3.1

(c) **<u>Reporting vehicle</u>: The requirement could be added to the value for members assessment which forms part of the Chair’s Statement and published annually.**

(d) **<u>Updating frequency</u>: The explanation of whether it is in members’ interests to consolidate should be updated at least every 3 years, and after any significant change in size or demographic profile.**

Encouraging schemes to consolidate on other grounds

32. We could also select groups of schemes to explain why they do not consolidate on other grounds, for example based on indicators from the composition of the board of trustees, such as sustained gaps in essential areas of knowledge across the board of trustees as a whole.

33. This sort of an approach is potentially attractive, as it does not make the assumption that all small schemes lack the robust and appropriate governance to assess the merits of more innovative investments, or are unable to access illiquid investments.

34. However we recognise that an approach of this sort would be more nuanced and would potentially be much more difficult for trustees to apply, or for The Pensions Regulator to verify. It would also need to recognise the ability of trustees to develop and improve with experience and training – and indeed the risk of gradually losing competence or skill through failing to maintain levels of knowledge and understanding.

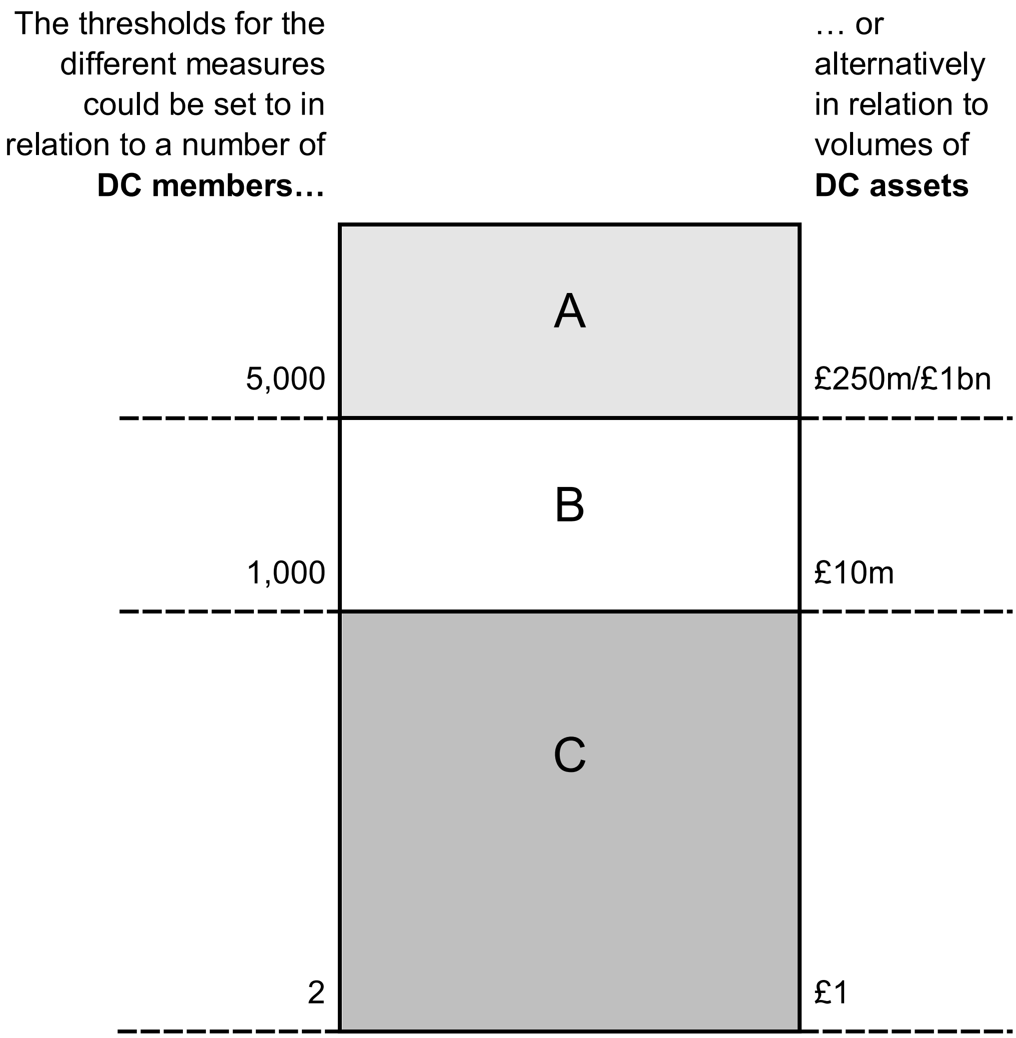
35. Other factors could be used to focus attention on schemes which should consider closure – for example closed schemes of below a certain size with a certain proportion of members below age 50 could be specifically required to consolidate, or to explain why they do not consolidate.

36. We would welcome views of these or any other indicators which might be used to identify schemes that should be encouraged or required to consolidate in a particular timescale.

Q5. What do you think about the use of indicators such as trustee knowledge and understanding, open or closed status or member demographics to identify and encourage schemes to consider consolidation? What indicators do you recommend and how could they best be communicated and verified?

Figure 6: Overview of the consultation proposals

Consultation options are separate. We may decide to implement only some or none of these.



A — Addition to Statement of Investment Principles and Implementation statement on policy and approximate holdings in relation to illiquid assets

B — No requirements

C — Triennial Statement on whether members would receive better value in a larger scheme.

Chapter 4: Illiquid investments, performance fees and the default fund charge cap

1. This chapter looks at whether the automatic enrolment charge cap acts as a barrier to investing in illiquid assets. We first explain the two methods for charge cap compliance, the different ways that performance fees are levied and consider the use of performance fees in illiquid investments. We then look at the extent to which such fees can already be accommodated within the cap. Finally, we explore whether and how an amendment to the charge cap might make it easier for trustees to consider investments with performance fees. For the avoidance of doubt, we are not proposing that any performance fees should be excluded from the cap.

The default fund charge cap

2. Since April 2015 there has been a charge cap on the default arrangements of DC schemes used for automatic enrolment[39]. Double defaulters - individuals who make no choice when they are automatically enrolled about either joining a pension or the fund to which they contribute - will be put in to a default arrangement. The cap was introduced to protect these members from excessive charges as we found no evidence that more expensive investment strategies consistently benefit members.

3. The charge cap was set at 0.75% of the funds under management each year or an equivalent combination charge. It includes most charges, but excludes transaction costs (the costs of trading) and the costs associated with holding and maintaining 'real assets' such as property and infrastructure. There is guidance for trustees of occupational pension schemes on how the charge cap works[40]. We have published updated draft guidance on the scope of the charge cap for consultation alongside this in Chapter 5 and in the Annex.

Existing methods of assessment

The retrospective method of assessment

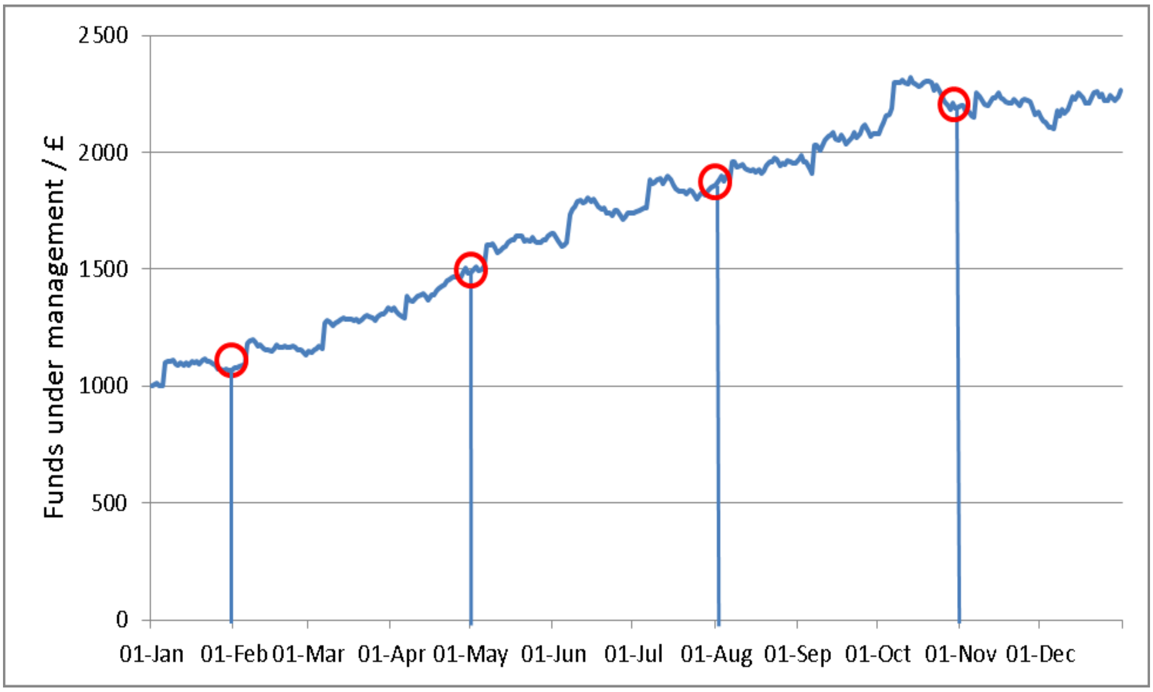
4. Trustees may choose from either the retrospective or prospective method for confirming compliance with the charge cap. In the retrospective method of assessment, trustees confirm compliance when the charge cap ceases to apply to each member, either because the member leaves or because the charges year

[39] Introduced by The Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879)
[40] The charge cap: guidance for trustees and managers of occupational schemes - https://www.gov.uk/government/publications/the-charge-cap-guidance-for-trustees-and-managers-of-occupational-schemes

ends. Schemes do this by calculating the average value of each member's rights based on assessments made at regular intervals throughout the year.

5. An example assessment is shown below.

Figure 7: Retrospective method of assessment - example



6. At the four reference points, the member's funds under management are as follows:

Date	**Value**
1-Feb	£1079.91
1-May	£1486.73
1-Aug	£1858.50
1-Nov	£2199.77
Average	**£1656.23**

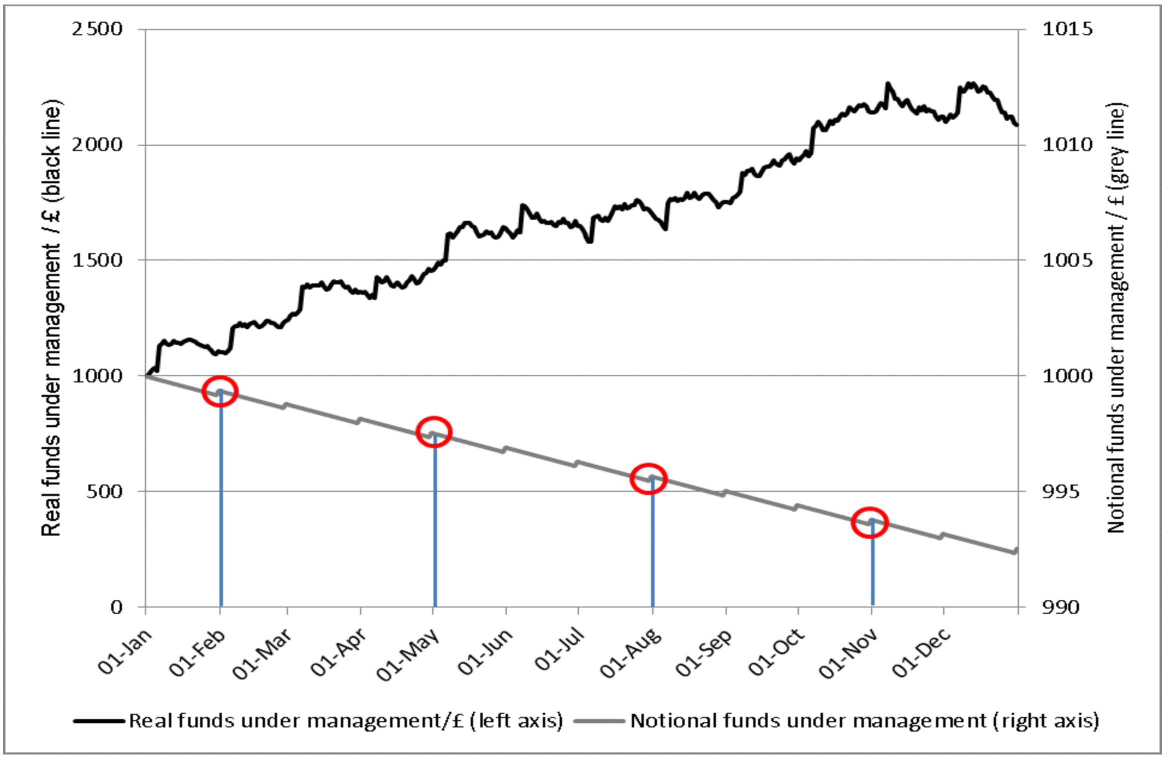
7. The maximum charge which may be imposed on the member for the year is 0.75% of this figure, or **£12.42**.

The prospective method of assessment

8. In the prospective method, trustees verify at the beginning of the charges year that the scheme's charging regime complies with the charge cap. As part of this methodology the scheme ignores fluctuations in fund value and member deposits and withdrawals during the charges year. Instead the calculation is made on the notional funds under management. The prospective method will only be suitable for schemes which have a predictable, repetitive charges regime.

9. An example assessment is shown below.

Figure 8: Prospective method of assessment – example



10. In this example, charges are levied at 1/365% of the fund's daily value each day of the month. On the final day of each month, the member is also given a rebate of the charges – this is why the grey line above shows a slight sawtooth pattern. The rebate is (m/365) x 0.251%, where m is the number of days in the month.

11. The value of the member's funds (ignoring fluctuations, contributions and withdrawals) on each of the reference points is shown below.

Date	Value
1-Feb	£999.34
1-May	£997.51
1-Aug	£995.63
1-Nov	£993.75
Average of reference point values	**£996.56**
31-Dec (year end value)	£992.54

12. In this example, the member started the charges year with £1000. Under the charges regime set out above, this member's funds under management in the absence of fluctuations, contributions and withdrawals would at the end of the year be £992.54. The total level of charges that would be imposed on this member, in the absence of fluctuations, contributions and withdrawals, would therefore be £1000 - £992.54 = £7.46.

13. Expressed as a percentage of the average of the fund value at the 4 reference points, the charge for this member would be £7.46/£996.56, or 0.749%.

14. Our industry engagement suggests that most schemes opt for the prospective method. We are told that schemes find this less burdensome as they can confirm on a ‘once and done’ basis that the charging model is such that the charges levied on each member cannot breach the cap, rather than having to verify for each individual member at the end of the charging year.

Performance fee practices

15. There are broadly two approaches which investment managers may take to charging fees. The first is a fixed funds under management charge, sometimes called an ‘ad valorem’ fee, where a fixed proportion of the funds under management is charged. The second approach is a performance related fee, where the total amount charged is at least partly linked to the performance of the fund.

Elements of a performance fee structure

16. There are a number of charging structures that funds with performance fees can take. They may have a fixed funds under management charge plus a performance fee element. Alternatively there may be no fixed fee, meaning the fee is entirely reliant on performance of the fund.

17. Fund performance will be measured relative to a benchmark, meaning the choice of benchmark is key to determining how much performance related fee is levied. The benchmark can be dynamic, generally with reference to one or more market indices, or set as a fixed percentage investment return.

18. There are fewer benchmarks for illiquid investments, so where funds offering this type of investment operate a performance related fee structure, the benchmark is more likely to be a fixed percentage return.

19. Performance fees aim to align the financial interests of the investment manager and the scheme members, making them almost solely levied in funds which are reliant on active investment management.

20. Other elements which may be included in a performance fee include:

- a cap – a maximum fee that may be charged regardless of fund performance
- a hurdle – a fixed minimum percentage return that can be combined with a dynamic benchmark so that, for example, a performance fee is not payable on negative returns (which could otherwise happen if the fund lost less than the benchmark)
- a high water mark – where performance fees are not earned until the best prior performance which has already earned a fee is reached
- a fulcrum fee – where the overall fee increases with outperformance and decreases with underperformance

- clawback – where a refund of some performance fees becomes due if accumulated performance is below the benchmark over a certain period of time
- reserving or carryover – where performance fees are deducted from the fund but not paid straight to the investment manager. Fees are held in reserve, which can be used to refund fees for subsequent underperformance or make payments to the manager, if the performance is maintained.

21. Asymmetric performance fees are those which only vary with outperformance, whereas symmetric performance fees also reduce with underperformance. Fulcrum fees, clawback and reserving are all features that could be included as part of a symmetric fee design.

22. Another fundamental feature of a performance fee is the period over which performance is assessed. We have seen some examples which span several years with, for example, a payment for performance in year one not crystallising until year three. Fund managers tell us that this encourages long term, responsible investment practices and discourages excessive risk taking to increase fees in the short term. Reserving or carryover is another way of accounting for cumulative performance over an extended period.

Performance fees and illiquid investments

23. The practice for investing in illiquid assets can be quite different from investing in more liquid asset classes. For example, listed equities and bonds are traded on an exchange whereas trading illiquid assets will inevitably involve additional steps such as finding a buyer/seller, and negotiating to establish the price. There are also likely to be significant research and valuation costs required in advance of any trade. These considerations demonstrate why investment in illiquid assets is likely to require some level of specialist active management.

24. Throughout our informal engagement with the investment industry we have been told that funds which offer access to certain types of illiquid investments, such as venture capital and infrastructure, typically levy a performance related fee. This practice may derive from the need for specialist active management. It may also be one way to reassure trustees, before locking funds up, that the alignment of interest means they will not be paying high fees for poor performance. However, some have also suggested the use of performance fees in illiquid investments is more a matter of custom and should not be necessary for any such assets. The complex nature of some illiquid assets has meant they have historically been taken up by a small number of investors who are more accepting of performance fees in part because they may be more familiar with evaluating them.

Q6. To what extent are performance fees used or required for funds which offer illiquid investment such as venture capital, infrastructure, property, private debt and private equity? Are market practices changing?

Accommodating performance fees within the charge cap

25. We know that average annual charges for pension schemes which are subject to the charge cap are between 0.38 and 0.54%[41] of funds under management depending on the type of scheme. It is therefore clear that trustees have scope, within the existing level of the cap at 0.75%, to consider innovative investment opportunities which may attract higher charges, should they wish to. It may however be the case that the way compliance with the charge cap is currently determined does restrict trustees' options.

Issues with performance fees and the existing methods of assessment

26. The charge cap was introduced to protect members in the default fund from excessive charges. It was not intended to prevent access to certain asset classes. However, if access to certain illiquid assets is contingent on paying a performance fee, DC scheme trustees will want to confirm that such a performance fee is compliant with the charge cap. In addition, it is possible that some trustees might prefer to invest in liquid assets via funds with performance fee structures in an effort to better align interests of manager and asset owner, although our informal stakeholder engagement has so far revealed no evidence of that.

27. The retrospective method for assessing compliance with the charge cap gives an absolute value for the maximum charge for each member. This puts no restrictions on when or how the charge is levied and so can be used to accommodate most kinds of performance fee as long as there is a cap.

28. However, we understand that most trustees' preferred method of compliance is the prospective method – where, allowing for any fluctuations in the value of the fund, whether through investment performance, contributions or withdrawals, the charging regime is confirmed to be compliant in principle for any potential member, joining or leaving on any day of the scheme's charges year.

29. Pension schemes can invest directly in illiquid assets but much more commonly they access them via a fund composed of a mixture of liquid and illiquid assets. Using the prospective method can make it difficult for trustees to invest directly in funds which have a performance fee because this method operates on the assumption that all charges are known in advance.

30. Both methods of compliance require that fees are pro-rated for members who are only invested for part of a year. This presents a challenge for how to treat members who are invested for a part of the charges year when this coincides with out-performance and so a performance fee is levied.

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[41] Pension Charges Survey 2016 – https://www.gov.uk/government/publications/pension-charges-survey-2016-charges-in-defined-contribution-pension-schemes

Existing solutions

31. Schemes of sufficient size may be able to negotiate for a fixed fee with the managers of funds who would usually charge performance fees, and we understand that this is already happening to a degree. Indeed we are aware of investment managers who have met client demand for certain illiquid investments by producing variants of funds with capped performance fees, or no performance fees at all. However, smaller schemes which have fewer resources to commit to alternative asset classes, may not carry the same influence or be in a position to negotiate on the same terms.

32. We are aware of other ways that schemes have been able to access funds with performance fees. One example is via a blended fund, where the investment manager sets a fixed price incorporating what they anticipate the performance fee of the underlying fund to be. If the fund outperforms expectations the investment manager absorbs the additional fee.

Q7. To what extent is the charge cap compliance mechanism a barrier to accessing funds which charge a performance fee? Does this act as a barrier to accessing certain asset classes?

Considering the use of performance fees in defined contribution schemes

33. There is debate around the merits of performance fees: whether the alignment of interests works to deliver higher returns net of costs; whether they inappropriately incentivise riskier investment practices; and to what extent they can be fairly applied to members of DC schemes. It is a matter for trustees to determine whether a fund offers value for their scheme but they will want to consider the terms of any performance fees carefully.

Good practice in performance fees

34. The International Organisation of Securities Commission (IOSCO) – of which the UK's financial services regulator, the Financial Conduct Authority (FCA), is a member – have looked at charging practices, including performance related fees and produced guidance on good practice[42]. We have also considered other research in to funds with performance fees. Whilst these typically focus on equity funds, there are potentially helpful findings in relation to the effects of performance fees in other asset classes.

35. On alignment of interests generally, the Centre for Asset Management Research at Cass Business School produced a report[43] examining the attractions of different fee structures to investors and fund managers. It found that the interests

[42] Good Practice for Fees and Expenses of Collective Investment Schemes Final Report, August 2016 - https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf
[43] Heads we win, tails you lose, October 2014 - http://openaccess.city.ac.uk/16840/

of investors and fund managers are more closely aligned with symmetric performance fees than with either a fixed funds under management charge or an asymmetric performance fee.

36. In considering whether a fund which levies a performance fee offers higher returns net of fees than other funds, analysis[44] carried out by the London Business School found that they did not. It found that this was mostly due to a subset of funds that did not use a dynamic benchmark or that set a benchmark that is too easy to beat. IOSCO good practice addresses the risk of setting a poor benchmark by recommending that the benchmark should be verifiable and provided by an independent party. This may be more challenging when there is no obvious index to track but trustees will at least want to assure themselves that any benchmark is not easily beaten or open to manipulation.

37. The London Business School report also considered the risk profile of funds with and without performance fees. It concluded that there is little evidence that funds with performance fees take more risk, particularly when the fee incorporates a high water mark. IOSCO goes further, suggesting that a symmetric performance fee, which offsets cumulative losses against cumulative gains, is used to reduce the likelihood that fund managers would take inappropriate risks. For asymmetric performance fees IOSCO good practice states that to discourage increased risk-taking, performance fees should not be paid more than once a year.

Attributing performance fees to the beneficiaries of outperformance

38. Ensuring that a performance fee is shared fairly amongst members represents a challenge in a DC scheme where members can join and leave at any time. For example, where a member transfers in after a period of outperformance but before the performance fee is calculated that member could end up paying for growth their investment has not benefited from. In fact, that member may pay twice for the same good performance as they may have already paid an increased price to join the fund, based on earlier growth.

39. This cross funding between members could be avoided if the performance fee was calculated separately for each member, however this may not be practical within current systems. IOSCO suggests that one way to minimise the impact of this unfairness is to accrue the performance fee on each day the value of the fund is calculated. Indeed we are aware of investment funds which have adopted this approach for the DC market.

40. Whether a performance fee represents value for members will ultimately be a decision for trustees. There are risks in considering performance fees. Performance fee regimes can be poorly structured, and drive short term investment practices, levy fees for below market returns, or share fees unfairly between members. However the research we have considered indicates that

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[44] The Costs and Benefits of Performance Fees in Mutual Funds, December 2018 - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3250315

trustees can mitigate against each of these risks by considering the terms of a performance fee contract carefully. Trustees will wish to pay close attention to the benchmark beyond which a performance fee is paid, as well as how underperformance is treated and how the fee impacts individual members' pots.

41. We return to this point in paragraphs 54-63 below.

Additional method of charge cap compliance

42. As already set out, Government remains committed to the charge cap in the default arrangements of DC schemes used for automatic enrolment. It plays a key role in supporting members of default funds to save enough for their retirement and protecting them from high fees and charges. Nevertheless we are keen to understand whether the charge cap could work better for schemes which are considering investment in funds which levy performance fees.

43. We would like to explore an extension to the way compliance with the charge cap is measured, to make it easier for trustees to consider investments which levy performance fees, whilst retaining the same level of protection for members.

The additional method of assessment

44. To allow for the situation where members are charged a combination of known in advance 'fixed rate fees' and variable 'performance related fees', we propose an extension to the existing prospective method of assessment, using an additional performance-related fee-specific method of assessment.

45. Trustees would first need to assess the known in advance, fixed rate fees alone according to the prospective method. They would need to verify that the charges regime is such that, whatever the joining and/or leaving date of a member during the charges year then, as long as there are no other changes in the value of the member's pension pot through that year, the member will pay no more than 0.75% pro-rated for the part of the year in which they were invested.

46. If trustees also wanted to accommodate a performance fee they could then carry out an 'additional assessment'. This would take the special case of a member invested for a full charges year, with no contributions or withdrawals. The fixed rate fee would be calculated in the same way as before, with no changes in the value of the member's pension pot through that year. The sum of these known in advance, fixed rate fees and the maximum possible performance fee which might be levied over the charges year must not exceed 0.75% of the funds under management.

47. The funds under management themselves are the funds at the start of the charges year. Since typically the member's pension pot will be bigger at the end of the charges year than at the beginning, using the year start value of the member's pension pot confers more member protection than using another value for the funds under management.

48. Expressing this as an equation, we would be proposing that two conditions must be met as follows:

For any combination of joining or leaving date in the charges year, with no subsequent contributions or withdrawals:

$$\frac{\text{Fixed rate fee (if no change in funds under mgmt)}(£)}{\text{Year start funds under mgmt (at start of year} - \text{ or point of joining, if later)}(£)} \leq 0.75\%$$

For any value of pension pot at the year start, with no subsequent contributions or withdrawals, then over a whole charges year:

$$\frac{\text{Fixed rate fee (if no change in funds under mgmt)}(£) + \text{Max performance related fee }(£)}{\text{Year start funds under mgmt (if no contributions or withdrawals)}(£)} \leq 0.75\%$$

How the additional method of assessment would work in practice

49. Whilst complex in theory, we believe that the additional method of assessment is relatively straightforward for trustees to implement in practice. Trustees can calculate the maximum permissible performance fee by first estimating how much of the 0.75% charge cap has been accounted for by the fixed rate fee calculated in line with the existing prospective method of assessment.

50. For example, if the fixed rate fees equal 0.50% of the year start funds under management (minus the fee) the maximum performance fee that can be levied over the charges year would be 0.75% - 0.50% or 0.25% (of the year start funds under management, again assuming no contributions or withdrawals).

51. Whilst in practice members will contribute to or withdraw from their pension pot, the verification of the performance fee level only needs to be carried out for a notional member invested at the beginning of the charges year, who remains invested at charges year end, and who has not made subsequent contributions or withdrawals.

52. For an example where the maximum permissible performance fee is 0.25%, as in the example above, the following performance fee structures could be accommodated in the cap, in relation to a default arrangement where 20% of the fund was allocated to an illiquid fund charging a performance fee. In each instance, the maximum performance fee would account for 0.25% of the year start funds under management.

- A performance fee of 12.5% on net returns above 5%, capped at 15%
- A performance fee of 20% on net returns above 6.5%, capped at 12.75%
- A performance fee of 25% on net returns above 7%, capped at 12%.

53. These examples are cited only for simplicity. In some instances, it would be more appropriate for schemes to adopt a performance fee structure relative to an appropriate index or indicator, such as CPI, rather than absolute net returns.

Q8. Do you agree that we should permit the additional method of charges assessment? Do you envisage any problems with complying with this method of assessment, or any reasons why it might disadvantage members?

Frequency of deductions and combination charges

54. Any legislative change carries a risk of unintended consequences which could potentially lead to poorer member outcomes, which we take extremely seriously.

55. We do not intend to legislate in detail for the kind of performance fee structure which pension schemes might adopt. We believe however that pension scheme trustees should carefully consider the IOSCO good practice guidance in working with investment managers to agree an appropriate performance fee approach. Furthermore, we believe that they should abide by those guidelines unless there are strong reasons why it is not in members' interests not to do so.

56. We would welcome respondents' views on whether it may be beneficial for the Department to publish guidance, which could carry statutory weight, on appropriate performance fee structures to make this point clear.

57. We also wish to ensure as much as possible that members of DC schemes are only subject to fees in relation to performance from which they have benefited. For example, if a scheme used a performance fee which was levied annually in relation to the preceding year's performance, a member joining at the very end of the charges year would pay for historic performance none of which they would have experienced.

58. In line with the IOSCO best practice guidelines, we believe that risk is most effectively mitigated by frequent calculation and accrual[45] of fees. This frequency of accrual may need to be higher than the minimum frequency of calculation and deduction of fixed rate fees for the method of assessment due to the variable nature of performance-related fees.

59. We are mindful of trustee burdens and limiting the market for fund innovation in this respect, but we are also conscious of the loss of confidence in the protection afforded by the charge cap if members are charged in excess of the cap, on a pro-rated basis, in relation to a period of outperformance from which they have not in fact benefited.

[45] By accrual we mean that the fees are calculated and the value of the fund is adjusted to reflect them. They are not banked (crystallised) by the investment manager. The fees would however constitute a charge, unless they are refunded to departing members.

60. We therefore propose as a safeguard to set out in statutory guidance (which trustees must have regard to) that performance fees should be calculated and accrued each time the value of the fund is calculated.

61. However, there would be no requirement for the fees to be crystallised and paid to the fund manager on the same frequency. We would welcome views on the viability of this approach in practice and on whether further member protection is needed, for example a minimum or maximum frequency with which the performance fee may be crystallised by the investment manager, or any robust evidence as to whether the safeguard we have proposed might be disproportionate.

62. Finally, we note that the then Office of Fair Trading expressed concern in its Defined Contribution Workplace Pensions Market Study[46] about the comparability of complex ‘combination charge’ structures. These might include separate percentage charges on contributions and funds under management as well as flat fees (historically known as policy fees) which are levied at the same rate irrespective of the value of the members’ pension pot. As part of the introduction of the charge cap, Government set a principle that savers invested in the default arrangement of schemes used for automatic enrolment should be exposed to no more than 2 types of charge. We therefore permitted:

- A charge levied solely as a percentage of funds under management.
- A funds under management charge combined with a percentage contribution charge.
- A funds under management charge combined with a flat fee.

63. We have committed to review the range of permitted charging structures in 2020, to see whether a simplification is needed to protect consumers[47]. We therefore believe that permitting further complexity by allowing performance fees to be levied alongside a combination charge structure at this time would be inappropriate, as it would further limit the comparability of pension scheme costs and charges. To avoid creating further unnecessary complexity, we therefore propose to only permit the operation of a performance fee structure alongside a charge levied solely as a percentage of funds under management.

[46] https://webarchive.nationalarchives.gov.uk/20131101172428/http://oft.gov.uk/shared_oft/market-studies/oft1505

[47] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-11-16/HCWS249/

Q9. We propose that:

(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.

(b) We should in particular specify in statutory guidance that performance fees should be calculated and accrued each time the value of the fund is calculated.

(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees.

We would welcome respondents' views on all these points.

Chapter 5: Updated charge cap guidance

1. This section introduces and consults on additional non-statutory guidance on the scope of the charge cap. The Department has received a modest number of queries over whether particular costs or charges are intended to be subject to the cap. We believe that with the increasing diversification in investments which this consultation aims to facilitate, the volume of queries might increase unless pre-emptive clarification is issued.
2. The updated list of charges and costs at Annex A sets out the Government's policy intent. This is a non-exhaustive list. We recognise that practice and terminology can vary across investment participants and asset classes, and will develop over time. Therefore trustees are encouraged to seek advice where necessary to assure themselves of the charge cap's application.
3. Stakeholders have made other suggestions in relation to guidance, including bringing together the existing non-statutory charge cap guidance[48] and the statutory guidance on cost and charge disclosure[49], and setting the combined document on a statutory footing. We have also been made aware of a lack of certainty or outright confusion on the part of some trustees over what their duties in relation to charges involve. We intend to produce further guidance on these points this year.

Additions to charge cap guidance

4. The main additions and clarifications to charge cap guidance are covered below. Like the charges and costs themselves, this is not an exhaustive list.

Fund types

5. A small number of stakeholders appear to have faced confusion over whether **investment trusts** are in scope of the charge cap. Whilst we originally cited only UCITS as an example underlying fund in an investment portfolio, we have been clear that all member-borne deductions relating to investment administration were intended to be subject to the cap. As well as investment trusts, we have added further types of investment including **unit-linked contracts of insurance, NURS (non UCITS retail schemes), and QIS (qualified investor schemes)** to the non-exhaustive list to make clear that this is a broad definition.

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[48] The charge cap: guidance for trustees and managers of occupational schemes - https://www.gov.uk/government/publications/the-charge-cap-guidance-for-trustees-and-managers-of-occupational-schemes

[49] Reporting costs, charges and other information: guidance for trustees and managers of occupational pension schemes - https://www.gov.uk/government/publications/reporting-costs-charges-and-other-information-guidance-for-trustees-and-managers-of-occupational-pension-schemes

Costs incurred in underlying firms and physical assets

6. Some stakeholders have taken this line of enquiry further and wondered about the circumstances in which trustees should 'look through' investments into the underlying running costs of those investments. We have made clear that our intention is always that there should be look through in investment funds, for example in fund of fund structures.

7. However, we agree that there are certain points in the investment chain in which look through would be perverse or contrary to the policy intent. For example a pension scheme holding shares in a supermarket would not consider the staff wages, heating, lighting and sourcing costs incurred by the supermarket as contributing to the cap. Likewise where a pension scheme had invested in a company which, incidental to its business, owned office accommodation, but whose core proposition was providing facilities management services to tenants, there might be an expectation that this differed from a pure investment company which only bought and sold property and outsourced servicing to a third party.

8. We have sought to clarify this distinction by adding to the list of exclusions **costs incurred by investee firms which have a general commercial or industrial purpose**, rather than firms whose predominant activity is the supply of financial services. As this will be a nuanced decision, we would encourage trustees to consider legal advice or ensure they have some 'headroom' in the cap to accommodate the relatively small number of firms for which such a distinction might be finely balanced.

9. We previously explained in our October 2016 update to the charge cap guidance that the costs of holding and maintaining property were excluded from the cap. We have sought to make clear that our intention here was a principle-based exclusion, not limited to property alone. Therefore we have referred to excluding **costs solely attributable to holding physical assets**, which would not only include infrastructure but also commodities such as gold. The costs incurred as a result of buying or selling such assets would remain transaction costs. Costs solely attributable to holding physical assets are not subject to the cap.

Private equity costs

10. A small number of stakeholders have asked about the Government's intention in relation to the treatment of private equity costs. Costs which are wholly offset against ongoing management fees do not need to be considered as costs at all – otherwise they would be double counted, as the management fee is already considered as a cost for the purpose of the cap.

11. It is our intention to cap any costs which are not offset, such as ongoing management services **(monitoring costs)** and fees paid to principals of the firm sitting as directors **(directors' fees)**. These are qualitatively different from the costs incurred by investee firms described above, as these fees are paid to the investment manager. **Carried interest** is essentially a performance fee and therefore subject to the cap.

12. However private equity costs which are incurred as a result of buying and selling assets, such as **underwriting fees** (when firms are taken private or refloated), and **success fees** (paid by the purchased company to the private equity firm on the closing of a deal) would constitute transaction costs.

Other costs

13. With the ban on soft commission and bundled research introduced by MIFID II, we have added **research costs** – which will now typically not be incurred as a result of buying, selling, lending or borrowing assets – as a charge which is subject to the cap. However, in recognition of the fact that some services are bundled with dealing costs in other jurisdictions, we have also retained research as a potential transaction cost.
14. Finally, we have clarified that **fund entry and exit costs** are intended to be treated as transaction costs, and added a range of costs which we believe trustees have generally-recognised that it was our intention to cap, but which were not specifically itemised – and therefore on which confusion may emerge in the future. This includes **costs of fiduciary management, marketing and distribution, compliance, litigation, financial guarantees, engagement and voting**.
15. We welcome comments on whether the guidance at Annex A provides clarity, and if not, where further clarity is required. We are not seeking feedback on whether particular costs should or should not be subject to the cap.

Q10. Do you believe that the updated non-exhaustive list of costs and charges provides increased clarity about the scope of the charge cap? Are there any areas where further clarity might be required?

Chapter 6: Impacts of these proposals

16. This section seeks evidence on the impacts of the proposals set out in this consultation. Our initial thinking on each policy proposal are set out below. We would welcome any evidence or views from stakeholders on each.

Stating the policy on illiquid investments

17. This measure would apply to a relatively small subset of DC pension schemes. We anticipate that this is an aspect of scheme investment governance which trustees' fiduciary duties to deliver an appropriate risk-adjusted return mean that they should already be considering, although for many schemes this may not have been formally documented or included in the Statement of Investment Principles.
18. We therefore expect the overall cost of this measure to be low.

Reporting annually on illiquid investment holdings

19. This measure would also apply to a relatively small number of schemes. If trustees were required to state their exact holdings of illiquid investments across all funds this measure might be burdensome, and require line-by-line consideration of whether holdings should be classified as illiquid.
20. We have sought to limit the burdens associated with this measure by being explicit that schemes would only be required to state their approximate holdings in illiquid assets in their main default funds only, and offering them flexibility of how this is broken down. We therefore expect this measure to also have low overall burdens.

A triennial statement on whether it might be in members' interests to consolidate

21. This measure would apply to a much larger number of schemes. We would expect the relative value of the scheme for its members to be something trustees are already considering in line with their fiduciary duties and as part of their assessment of value for members. However, we believe that relatively few will have documented their conclusions on whether members would be better off if the scheme consolidated.
22. We therefore believe that the costs associated with this measure might be higher.

Additional method of assessment with the charge cap

23. This measure offers pension schemes a new way of verifying charge cap compliance for the instances where they have performance fees. It does not amend existing methods of assessment or require anyone to adopt this method of assessment. As it is entirely permissive, we therefore believe that the business impacts associated with this measure are zero.

Q10. We would welcome views and any estimated costing for the impacts of these proposals.

(a) Stating a policy on illiquid holdings

(b) Reporting on illiquid holdings.

(c) Considering and reporting on whether it might be in members' interests to consolidate

(d) The additional method of assessment with the charge cap.

Annex

In scope of the default fund charge cap:

all member-borne deductions relating to scheme and investment administration paid to the pension provider or another third party

Administration costs

- Set-up fees
- Costs of member communication services, e.g. statement costs, website, printing/ posting accounts
- Ongoing costs for running of scheme, e.g. IT, office and staffing costs, data management and record keeping, marketing and distribution
- Scheme-level entry fees; both on entry into, or on transferring a pre-existing pot into, the scheme
- Scheme-level exit charges
- Banking fees
- Fees and expenses charged in relation to the creation or operation of any funds or collective investment schemes
- Scheme level payments to providers of professional services and other third parties, or fees for related services, e.g. administrators, advisers, actuaries, lawyers, auditors, accountants, compliance and litigation.

Governance and regulation costs

- Registration and regulatory costs and fees
- Fees paid to governance bodies, e.g. trustees, IGCs and others
- Governance charges and expenses, e.g. trustee insurance

Investment costs (except as permitted in relation to physical assets)

- Fund or investment management fees, including payments to investment consultants and fiduciary managers, underlying, separate and in-house fund managers, performance fees, research, engagement and proxy voting advisers
- Ongoing charges for underlying funds in investment portfolio, e.g. fee for holding units in a UCITS, NURS or QIS fund or investment trust
- Ongoing charges for unit-linked contracts of insurance
-
- Fees (excluding transaction costs) for non member-initiated switching of funds
- Investment level payments to providers of professional services and other third parties or fees for related services, e.g. investment governance, advisers, audit and legal fees, valuation services, levies, compliance and litigation costs.
- Costs of third party financial guarantees e.g. capital guarantees
- Depositary fees and fees to the custody bank (excluding transaction costs)
- Platform fees
- Unrecoverable VAT
- (private equity) carried interest, unoffset monitoring fees and directors' fees

Excluded from the default fund charge cap

Transaction costs

- Dealing commission and fees, including payments for other goods and services provided in return, e.g. research
- Transaction taxes, e.g. stamp duty and capital gains tax
- Spreads, e.g. bid-offer on bonds, foreign exchange (and associated costs such as commission)
- Dilution levy, fund-level spreads and the costs resulting from swing pricing
- Other charges embedded in the transaction price, e.g. payments incurred through financial derivative instruments
- Custodian transaction costs (‘ticket fees’)
- Deductions of expenses or fees from income earned by other transactions relating to the underlying assets, e.g. stock lending, foreign currency exchange
- Physical assets transaction costs e.g. lease renewal fees
- (private equity) unoffset transaction fees, including underwriting fees and success fees

Taxes

- Non-reclaimable withholding taxes on income, dividends and interest

Costs solely attributable to holding physical assets

- Property management and maintenance costs
- Valuation fees
- Void costs
- Insurance
- Ground rent charges
- Rates and taxes

Other exclusions

- Costs incurred by investee firms which have a general commercial or industrial purpose, e.g. the wages paid to staff in a retail store
- Costs of winding up the scheme
- Costs incurred in complying with a court order
- Permitted charges in respect of pension sharing costs
- Costs solely associated with the provision of death benefits