Department
for Work &
Pensions

Enabling Investment in Productive Finance

Policy consultation on proposals to remove performance-based fees from the charge cap

November 2021

Contents

Contents

Introduction 3

About this consultation 3

Who this consultation is aimed at 3

Purpose of the consultation 3

Scope of consultation 3

Duration of the consultation 3

How to respond to this consultation 3

Government response 4

How we consult 4

Consultation principles 4

Feedback on the consultation process 4

Freedom of information 4

Ministerial Foreword 6

Chapter 1: Summary 7

‘Incorporating performance fees within the charge cap’ consultation 8

Performance fees as a barrier 8

Smoothing mechanism 10

Developments since June 2021 11

Productive Finance Working Group 11

Taskforce on Innovation, Growth and Regulatory Reform 13

Chapter 2: Performance fees 14

Policy Proposals 14

Rationale for change: removing barriers to investment, and encouraging performance fee innovation and competition 14

Next steps 23

Introduction

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

The Government is consulting on proposed changes to the regulatory charge cap that applies to the default funds of occupational defined contribution (DC) pension schemes used for automatic enrolment. This is to inform future policy to help ensure DC schemes are able to access a broader range of illiquid asset classes that have the potential to result in positive outcomes for members.

Scope of consultation

As pensions policy is a reserved matter for Scotland and Wales, this policy consultation applies to Great Britain. Occupational pensions are a devolved matter for Northern Ireland.

Duration of the consultation

The consultation period begins on 30 November 2021 and the final date for submission of responses will be 11:45pm on 18 January 2022.

How to respond to this consultation

Please send your consultation responses via email to:

DC Policy, Investment and Governance Team at the shared address:

pensions.investment@dwp.gov.uk

Note: When responding please indicate whether you are responding as an individual or representing the views of an organisation.

It is most useful for the Government if organisations issue their response as a Word document. If respondents wish also to provide a PDF, they can do so.

Government response

We will aim to publish the Government response to the consultation on the gov.uk website in early 2022.

How we consult

Consultation principles

This consultation is being conducted in line with the revised Cabinet Office consultation principles published in 2018. 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), please email them to the DWP Consultation Coordinator. These could include if you feel that the consultation does not adhere to the values expressed in the consultation principles or that the process could be improved.

DWP Consultation Coordinator

caxtonhouse.legislation@dwp.gov.uk

Freedom of information

The information you send us may need to be passed to colleagues within the DWP, 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.gov.uk

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

Ministerial Foreword

As automatic enrolment has developed we want to ensure optimal outcomes for the nation's defined contribution (DC) saver. The trustees of DC schemes are increasingly looking to private markets to deliver on this responsibility due to the benefits of diversification and greater returns. Investment in asset classes like green infrastructure, private equity and venture capital, fits well with the long-term horizons of DC schemes. Such investments have the potential to provide better returns for members as part of a balanced portfolio and help to sustain employment, our communities and the environment. We are proposing to increase the flexibility trustees have to access a range of assets whilst ensuring members are protected from predatory charges.

In the last few months, the Government, alongside industry and regulators, has made significant steps towards addressing the barriers to investment in long-term illiquid investments in the UK. In September 2021, the latest milestone was achieved with the publication of the final report of the Productive Finance Working Group.

As the Chancellor announced at Budget, we are now consulting on this new policy. Proposals outlined in this consultation focus on removing well-designed performance-based fees from the list of charges which are subject to the regulatory charge cap.

We believe that this change will give schemes the flexibility and freedom to pay performance-based fees, if they think this will be in the financial interest of members. At the same time, it is essential that members continue to be protected. As I reaffirmed in January 2021, the charge cap continues to serve an important role.

Guy Opperman MP, **Minister for Pensions and Financial Inclusion**

Chapter 1: Summary

1. We are committed to doing all we can to ensure trustees of occupational defined contribution (DC) pension schemes are able to take advantage of long-term, illiquid investment opportunities where they feel they are in their members' best interests. The DWP will continue to look at ways to remove structural barriers that currently prevent them from doing this. We also want to ensure that the current protections in place to protect members from high and unfair charges are not diluted.

2. This consultation seeks views on policy proposals to change the treatment of fees that are based on the investment performance of the underlying assets, commonplace in private markets such as venture capital, so that they do not fall within the 'charge cap'. It also seeks views on appropriate mechanisms to include within policy design to ensure that member protections are maintained.

3. The charge cap, introduced in 2015, applies solely to the default funds of DC schemes used for automatic enrolment (excluding certain schemes, such as schemes with only one member) and covers all member-borne administration charges associated with scheme and investment administration, excluding transaction costs and a small number of other specified costs and charges. It prevents schemes from imposing charges of more than 0.75% annually of a member's pot.

4. As the Chancellor of the Exchequer announced in his Budget 2021:

   "*We will consult on further changes to the regulatory charge cap for pension schemes, unlocking institutional investment while protecting savers.*"

5. This consultation considers options to amend the scope of the charge cap to better accommodate well-designed performance fees. We want to explore the impact any changes in this area could have on member protection and in helping to deliver better outcomes for savers.

6. The Taskforce for Innovation, Growth and Regulatory Reform[1], the Productive Finance Working Group[2] (PFWG) and others have suggested a change in this

---

[1] Taskforce on Innovation, Growth and Regulatory Reform independent report - GOV.UK (www.gov.uk)

[2] working-group-on-productive-finance

area would give trustees of occupational DC pension schemes, more flexibility to access less liquid investment classes which could improve the retirement prospects of their scheme members.

7. This document outlines our proposals to take further action to remove barriers to provide greater flexibility, whilst encouraging a new approach to fee structures in private market asset classes like venture capital; we want to create a regulatory environment for occupational DC schemes that encourages genuine innovation and competition on value delivered. We want these changes to benefit savers when investments have performed consistently well in the long-term, whilst simultaneously safeguarding them from predatory fees in cases of poor performance.
8. This document considers the evidence put forward by stakeholders in response to previous consultations as well as the recommendations from the PFWG.

‘Incorporating performance fees within the charge cap’ consultation

Performance fees as a barrier

9. The Chancellor announced in his 2021 Spring Budget, on 3 March 2021, that the Government would consult on whether certain costs within the charge cap affect pension schemes’ ability to invest in long-term, illiquid assets. He said:

   “This [change] is to ensure pension schemes are not discouraged from such investments and are able to offer the highest possible returns for savers. DWP will also come forward with draft regulations to make it easier for schemes to take up such opportunities within the charge cap by smoothing certain performance fees over a multi-year period.”

10. In March 2021 we published the consultation: *‘Incorporating performance fees within the charge cap’*. That consultation, which was informed by responses to the September 2020 consultation *‘Improving outcomes for members of defined contribution schemes’*[3], consulted on a legislative change to the way compliance

[3] improving-outcomes-for-members-of-defined-contribution-pension-schemes

with the charge cap is measured to give trustees flexibility to smooth performance fees over a longer period, avoiding the circumstance in which some members are punished for strong performance or trustees avoid such investments altogether due to the risk of a charge cap breach.

11. We explained that, although traditionally pension schemes have tended to dedicate the majority of their investment portfolio to public markets e.g. listed equities and bonds, as the DC market matures, some trustees are looking to access a more diverse portfolio of assets including illiquid assets that have the potential of even greater return.

12. Although some illiquid assets can be accessed without paying performance fees (e.g. some infrastructure and private credit) access to the most illiquid, higher risk but potentially highest potential gross return investments, like venture capital and other forms of private equity, can currently typically attract a performance fee. The reasons cited by investment managers for these higher fees is that such costs are often justified by the superior returns that may be achieved and that the investments can often involve specialist active management, extensive research, niche expertise and greater ongoing engagement with business managers.

13. We also explained that the structure of performance fees can vary. The most common structure being the combination of a fixed annual management fee, paid regardless of return, and a performance-based element which is payable upon returns exceeding a certain “hurdle rate”. This is often referred to as ‘carried interest’ and appears mainly in closed-ended fund structures with fees charged to the investor, i.e. crystallised, at the end of the life of a fund but accrued at intervals across the investment period.

14. The Government acknowledged that performance fee charges are highly unpredictable by nature given fluctuating performance, varying accrual periods and the potential for frequent member movement. This means that calculating the performance fees payable by an individual member can prove difficult for trustees.

15. As a result of stakeholders raising with us the prospect that the charge cap can sometimes prevent trustees from exploring investments that incurred performance fees for fear of breaching the cap, we responded to this call by consulting on a change which makes it less likely that the charge cap would be breached – this allows the ‘smoothing’ of performance fees over multiple years.

Smoothing mechanism

16. Regulations 7 and 8 of the Occupational Pensions Scheme (Charges and Governance) Regulations 2015 ("the Charges and Governance Regulations 2015") offer two different methods (retrospective and prospective) for calculating the charges that can be imposed on members for the given charges year[4]. Both methods require the level of charges for that year to be based on the costs and charges the scheme pays in the given charges year.

17. In the consultation *'Incorporating performance fees within the charge cap'* we proposed a legislative change which allows trustees and managers of relevant DC schemes to make an exception to this requirement, only in respect of performance fees. Instead of being required to look back on, in the case of the retrospective method, or predict, in the case of the prospective method, the performance fees incurred over the course of the charges year, trustees and managers can 'swap out' this figure for a 5-year moving average of accrued performance fees. The motivation behind this was to remove an often-quoted barrier to investing in illiquid asset classes where performance fees are standard, allowing schemes to accommodate the 'ebb and flow' sometimes associated with the performance of these assets and still remain within the charge cap.

18. Stakeholder responses to the consultation supported the objective of providing trustees with more flexibility when it comes to incorporating performance fees within the charge cap and agreed the new regulations would go some way to achieving the policy intent.

19. Overall, whilst recognising the positive intent from the Government, many respondents believed this change would have limited impact on trustees investing in illiquid assets. Suggestions were made that alternative or additional relaxations of regulations would go further to eliminating barriers to trustees choosing illiquid investments to diversify their portfolio. This included complete or partial removal of performance fees from the charge cap.

    "Strongly of the view that where performance fees relate to venture capital/growth equity investments, they should be excluded from the charge cap completely.

---

[4] "Charges year" is defined in regulation 2 of the Charges and Governance Regulations 2015.

Only performance fees relating to non-venture capital/growth equity investments should operate within your proposed smoothing framework."

Legal & General

"One impactful change that would significantly increase trustee confidence to invest in illiquids is to have performance fees not subject to the charge cap. In our view performance fees are more akin to a profit share mechanism and should not be categorised in the same way as other fees and charges within the cap."

Partners Group

20. We published the outcome of the consultation: *'Government Response: Improving outcomes for members of defined contribution schemes'* and accompanying draft regulations on 21 June 2021. These were published as part of the wider package of regulations – The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021)[5] – which supported the Government response both to this, and our 2020 consultation. The regulations came into force on 1 October 2021.

21. At the time, we recognised that the flexibility introduced by the regulations in giving trustees further confidence to invest in illiquid assets that generate performance fees would not be a 'silver bullet'. There are a number of other factors outside the charge cap that affect trustees' confidence to invest in illiquid assets such as a lack of scale, daily pricing, lack of suitable investment funds and a lack of belief in an illiquidity premium in prevailing market conditions. Whilst we will not reach a solution on the 'illiquids in DC' issue by tweaking the charge cap alone, it may help remove one of the barriers trustees face.

Developments since June 2021

Productive Finance Working Group

22. The Productive Finance Working Group (PFWG) was established in November 2020 by the Bank of England, HM Treasury and the Financial Conduct Authority;

[5] https://www.legislation.gov.uk/ukdsi/2021/9780348224788/regulation/2

DWP Ministers and officials were a key partner of the group. The key focus of the group was to develop practical solutions that remove current barriers to investment in long-term, illiquid assets by DC schemes.

23. In September 2021, the Group published its report *'A Roadmap for Increasing Productive Finance Investment'* that included key recommendations for industry, Government and regulators to allow members of occupational DC schemes to benefit from investment in longer-term, illiquid assets. The recommendations have been grouped into four overarching recommendations to be taken forward by industry and the official sector:

    - Shifting the focus to long-term value for DC pension scheme members.
    - Building scale in the DC market.
    - A new approach to liquidity management.
    - Widening access to less liquid assets.

24. DWP has worked closely with the members of the PFWG to try and find solutions to barriers preventing illiquid investment by occupational DC schemes. The Group acknowledged the progress that had been made through recent consultations in relation to the charge cap and consolidation but asked for further consideration of performance fees within the charge cap. The Group directly recommended that DWP:

    "*consider in the future how to reconcile performance fees with the purpose of the charge cap and trustees' ability to invest in a broad range of assets, including less liquid ones."*

25. Section 3.2 of the report goes into more detail. It suggests that, in order to reconcile investment in less liquid assets with performance fees, high-level principles and methodologies might be developed for performance fees for DC schemes in certain areas, such as:

    - principles for typical hurdle rates for performance fees across different asset classes;
    - accrual methodologies for performance fees;
    - linking performance fees to realised profits;

- considerations for circumstances where caps on performance fees might be appropriate; and
- incentivising the development of alternative fee methodologies such as ‘1 or 30’.

26. The PFWG also acknowledges in its report that the issues and solutions referred to in the report need further consideration and that changes to charge cap policy need to be considered fully by industry and official bodies.

Taskforce on Innovation, Growth and Regulatory Reform

27. The Taskforce on Innovation, Growth and Regulatory Reform (TIGRR) was announced by the Prime Minister on 2 February 2021. Its remit was to *“seek out opportunities to take advantage of our new-found regulatory freedom [post-Brexit], and to support innovation and growth.”*

28. In June 2021, the taskforce published its report *“Taskforce on Innovation, Growth and Regulatory Reform independent report”.* Sensible reform of DC pension scheme regulation was cited as an opportunity for unlocking investment in growth companies in the UK and securing better returns for UK pension savers. Proposal 2.1 echoes the PFWG Report:

    “Enable Defined Contribution (DC) pensions schemes to diversify their investments into venture capital and businesses that drive Net Zero and levelling up commitments.”

29. Under this proposal, the taskforce states that the largest barrier to trustees of DC schemes investing in long-term, illiquid assets is the calculation method which includes performance fees within the charge cap. They acknowledge the DWP’s successful progress with the smoothing mechanism regulation that came into force in October 2021 but suggest that there is further progress to be made. The body of the text in Proposal 2.1 echoes the PFWG Report:

    'Whilst we understand the rationale for the cap, it is also a key barrier. It does not accommodate long-term incentive models such as carried interest that benefit both investors’ returns and the growth trajectory of the companies the industry invests in'.

Chapter 2: Performance fees

Policy Proposals

Rationale for change: removing barriers to investment, and encouraging performance fee innovation and competition

30. The Government is determined to remove any barriers, real or perceived, to investments in any asset classes that could bring benefits to pension savers. A key barrier that has been raised consistently is ‘performance fees’. Mainly, this has focussed on the role that the charge cap plays in trustees’ investment decision-making when it comes to illiquid assets.

31. The PFWG report *‘A roadmap for increasing productive finance investment’* acknowledged the mixed views amongst industry participants on fees. Some large Master Trust providers have ruled out paying performance fees which they believe have historically been heavily tilted to favour the fund manager at the expense of genuine value for members. Private equity managers and their trade associations consider ‘carried interest’ to be the only way of aligning interests and incentivising managers to seek the best possible return on investors’ behalf.

32. To move forward, the Government would like to ensure that structural barriers to investing in assets which incur performance fees are removed. In addition, the Government wishes to encourage market participants to reform existing performance fee structures, taking into account the needs of DC schemes. The remainder of this document outlines our plans to encourage fee innovation and competition and reduce some barriers for trustees that want to consider investment in a wider range of investment opportunities.

Removing performance-based fees from the charge cap

33. The Government has listened to the recommendations of the PFWG and responses to previous consultations and is now taking action by consulting on possible further reforms. Our intention is to create a regulatory environment that allows pension scheme trustees to invest where they think they can achieve better value for members and which encourages genuine innovation and competition on fees, including on the part of investment managers. The questions

that follow will enable us to consider the full range of options and we encourage consultants, asset owners, investment managers, trustees, member representatives and others involved in occupational DC pensions to offer their views as we move forward.

34. The charge cap prevents schemes from imposing charges of more than 0.75% annually on a member's pot. However, there are some charges which are excluded and therefore not covered by the charge cap:

    - transaction costs (costs incurred as a result of buying, selling, lending or borrowing investments);
    - the amount of any costs incurred in complying with a court order, where the court order provides for the trustees or manager to recover those costs;
    - charges in respect of pension sharing on divorce orders, permitted by regulations made under section 24 or 41 of the Welfare Reform and Pensions Act 1999;
    - costs of winding up the pension scheme;
    - costs solely associated with the provision of death benefits;
    - costs solely attributed to holding physical assets, such as land or buildings.

35. We are now proposing adding to this list of exemptions. Specifically, the Government proposes adding to the list of charges currently out of the scope of the charge cap to include well-designed performance fees that are paid when an asset manager exceeds pre-determined performance targets.

36. This exemption would not apply to fees that are not related to performance. All other investment administration charges currently in scope of the cap would remain. This includes, for example, the fixed fee part of a standard carried interest model – the 2% fee of the traditional 2 and 20 performance fee – which would continue to be subject to the charge cap.

37. The Government believes that this arrangement would address the barrier, cited by some stakeholders, that variable fees like performance-based fees, are not suitable for regulation through a flat cap. In addition, this proposed change could effectively incentivise schemes and managers to reach fee agreements that link

payment of additional fees directly to the net benefit the scheme members receives. Previous consultations have indicated that the high fixed fees payable for some assets, such as venture capital, have deterred some trustees from investing in such assets. Therefore, this proposal may facilitate the development of fee structures, with lower base fees which are more palatable to DC schemes, if there is sufficient investor demand.

38. We believe that our proposal will give such schemes the flexibility and freedom to enter into performance-based fee structures if they think this will be in the financial interest of members. We also hope this will incentivise private equity and venture capital managers to design a new fees structure in the future that schemes can pay and are willing to pay.

39. We also want to understand the extent to which this change will affect trustees' concerns about the practicalities of performance fees. The combination of variable fees within a flat cap regime has been reported as a factor that limits trustees' confidence when it comes to investment in private markets. Whilst the practical difficulties of calculating member fees when a variable fee applies is not solved by this remedy, we believe that changes to the scope of the cap combined with smarter regulation of performance-based fees will address practical concerns linked to the flat cap regime.

40. It is also worth noting that some large schemes are currently in the midst of negotiating more appropriate fee structures to overcome operational issues with private equity managers and others. We would not wish to undermine this negotiation and interfere with market forces. Separately, many large Master Trust providers have already taken the view that they will not pay performance fees of any kind. The Government passes no comment on this recognising that this is a commercial judgement.

41. We also want to understand the extent to which this proposed change would trigger reform, by private equity and venture capital managers, from existing fee structures. If yes, would this therefore trigger greater investment in such assets by DC schemes? If no, would this make any difference to trustees' appetite for such investments?

42. A series of illustrative examples have been developed showing what the impact could be on fees of allowing DC schemes to charge members of the default arrangement uncapped performance-based fees. The modelling of the illustrative examples builds upon previous DWP modelling presented in the consultation

outcome to 'Incorporating performance fees within the charge cap' [6]. That analysis had itself been built upon previous work by the British Business Bank/Oliver Wyman[7].

43. Six scenarios are presented, each of which involve the fictitious DC pension scheme, Grow Pension. Grow Pension are keen to diversify the asset allocation of their largest default fund and are considering investing in a venture capital fund. In doing so Grow Pension are considering three different fee structures:

    - a "2:20" fee structure in which investors are charged a fixed annual management charge of 2% of assets under management (AUM) alongside a 20% performance fee on returns delivered above an 8% hurdle rate;
    - a "1:25" fee structure in which investors are charged a fixed annual management charge of 1% of AUM alongside a 25% performance fee on returns delivered above an 8% hurdle rate per annum;
    - and a "0:30" fee structure in which there is no fixed annual management charge but investors are charged a 30% performance fee on returns delivered above an 8% hurdle rate.

44. In each scenario, the total AUM in Grow Pension's default fund are £100 million. Average investment returns for the venture capital fund are assumed to be 15% pa in three of the scenarios and to be 20% pa in the remaining three scenarios (one for each of the fee structures mentioned above). For the other assets in the portfolio we have assumed the annual fee for the other assets is 0.4% with investment returns of 8.5%[8]. The full set of assumptions for the six scenarios are set out in Annex X.

45. Figure 1 presents the charges Grow Pension would measure if they were to invest 10% of their asset allocation in a private equity fund with returns of either 15% or 20% pa at each of the three different fee structures mentioned above. The

---

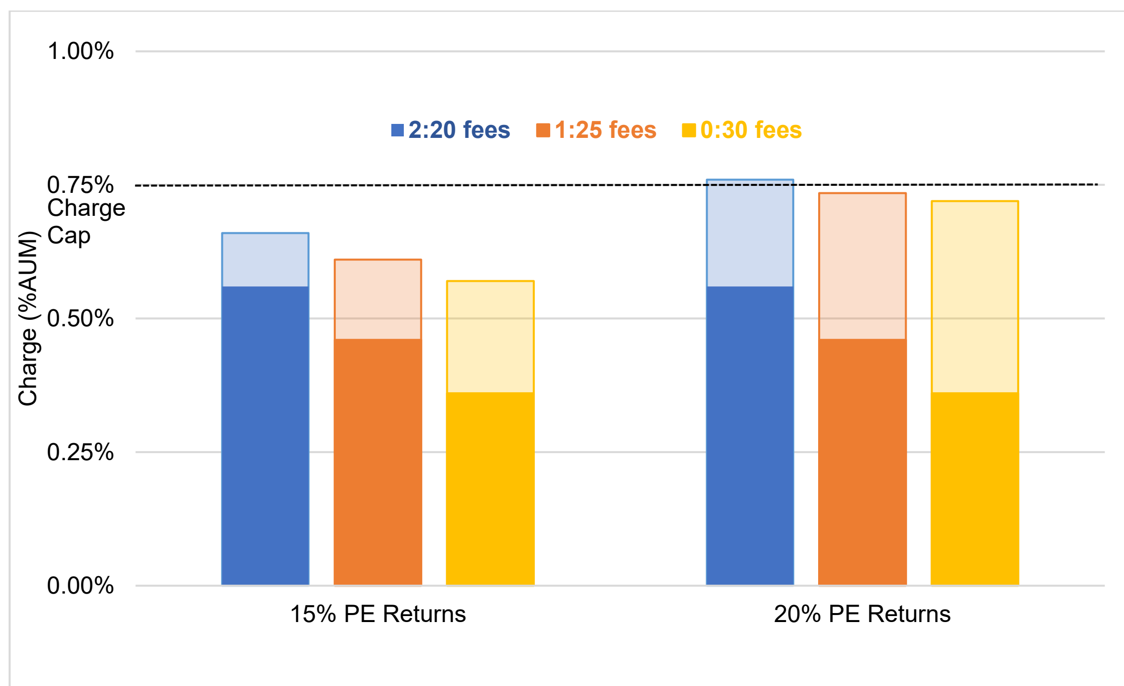
[6] https://www.gov.uk/government/consultations/incorporating-performance-fees-within-the-charge-cap/incorporating-performance-fees-within-the-charge-cap

[7] https://www.british-business-bank.co.uk/wp-content/uploads/2019/09/Oliver-Wyman-British-Business-Bank-The-Future-of-Defined-Contribution-Pensions.pdf

[8] 15% returns based on the upper quartile 10-yr annualised returns of 26 private equity funds listed on Morningstar Closed-end Fund Screener. 8.5% returns based on BBB/Oliver Wyman analysis using MSCI net returns data, 2004-16. ↩

main bolder-coloured part of each bar shows the non-performance fee related charges, including the fixed fee part of a standard carried interest model (e.g. the 2 of the traditional 2 and 20). The shaded part of each bar shows the performance-based fee part of the charge.

Figure 1 – Annual charges measured by Grow Pension for a 10% allocation to private equity investment, with varying fee structures and returns



46. Figure 1 shows that performance would have to be in the region of 20% net to breach the charge cap. But it does indicate that the headroom trustees enjoy would be eaten away by performance fees. Removing such fees from the cap reinstalls that headroom.

47. Clearly, charges would be well below the charge cap under all fee structures with a 15% annual return on private equity; regardless of whether performance fees are excluded from the cap. The region of genuine outperformance of 15-20% net returns therefore poses difficulties for schemes currently.

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would

this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

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

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

48. If we moved ahead with regulations to add performance-based fees to the list of charges which are outside of the scope of the charge cap, we would look to find ways of ensuring that members are only required to pay fees when genuine outperformance is achieved to ensure members savings and best interests are protected.

49. The Government is mindful of the potential for unintended consequences. Asset managers could reform existing fee structures for other asset classes to fit within this easement. For example, a passive manager could reform its existing 100bps flat fee (for mathematical simplicity) into a 40bps flat fee and a performance-based fee of 20% of profits that kicks in at 'inflation + 2%'. If inflation hits 2%, so the hurdle rate is 4% and performance reaches 10%, the scheme is now paying 160bps in total for the same product that previously cost 100bps. This risks making the product more expensive and reducing value to members in the event that high levels of performance above the hurdle rates are delivered.

50. The Government is committed to designing any change to the treatment of performance fees within the cap to protect against this abuse. See below some of the Government's policy design options to this end.

51. One other potential solution is to be specific about the asset classes to which this performance fee exemption would apply, namely venture capital, private equity, infrastructure, and/or private credit. As responses to previous consultations have indicated, this would bring definitional issues but may help to prevent unintended fee reform in other markets.

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding

the performance related element of performance fees to the list of charges outside the scope of the charge cap?

Q2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

52. In the name of member protection, the Government would consider creating a tighter definition of performance-based fees. The current definition of "performance fee" in regulation 2 of the Charges and Governance Regulations 2015 (inserted by the Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021) is as follows:

    "performance fee" *means a fee which—*

    a) *is calculated by reference to the returns from investments held by the scheme, whether in terms of the capital appreciation of those investments, the income produced by those investments or otherwise; and*

    b) *is not calculated by reference to the value of the member's rights under the scheme;*

53. The Government is considering whether to require a given hurdle rate, for each asset class, to prevent arbitrage/unfair practices from emerging. For example, without tight regulation, a manager could reform fees to charge 0 and 50 with a 0% hurdle rate. Such a structure would mean schemes sacrifice 50% of all positive returns.

54. The Government is also considering whether to add additional criteria to this definition in order to ensure our call for 'a new approach to fees' is met. One particular issue which we have heard is of particular concern to pension schemes is the unbalanced nature of existing structures. Trustees express nervousness that the 20% performance-based fee kicks in on outperformance but trustees are not reimbursed if performance then drops. Whilst the Government is considering several options to 'remedy' some of these concerns, there is a need for large schemes to exert their buyer power on both the level and structure of such fees.

55. Other design considerations include:

- principles for typical hurdle rates for performance fees across different asset classes;
- accrual methodologies for performance fees;
- linking performance fees directly to realised profits;
- circumstances when caps on performance-fee-incurring assets within the portfolio might be appropriate;
- incentivising the development of alternative fee methodologies such as '1 and 30';
- requirements for a high-water mark; and
- banning the practice of clawback.

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

56. Investor transparency on charges is a key priority for the Government. Trustees of occupational DC schemes must disclose in the annual Chair Statement, for the purpose of compliance with the charge cap, any charges that members invested in the default fund incur. Charges that are not within the charge cap are not required to be disclosed to the same extent. This means that there is often greater transparency on fees in scope of the charge cap and less transparency on fees that are out of scope.

57. In the case of one particular group of charges: transaction costs that are out of the scope of the charge cap, the Government decided that trustees should still be required to disclose to members, via the Chair's Statement, the transaction costs that members paid[9].

58. If the Government were to proceed, we propose making similar requirements about performance-based fees also needing to be disclosed to members in the Chair's Statement. A bad outcome in our opinion would be for trustees and

[9] Regulation 23(1)(c) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996.

members to end up with less transparency on fees as a result of this measure and we are keen to avoid such an outcome.

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

59. The Government consulted in March on a mechanism to allow schemes to smooth performance fees within the charge cap. In June, we introduced regulations which came into force on 1 October 2021 to allow schemes to do this.

60. However, we now propose removing the smoothing mechanism from regulations if we regulate to remove performance-based fees from the list of charges which are subject to the charge cap. Whilst this follows logically, we are keen to understand if you had plans to make use of the smoothing mechanism and whether changing course would significantly disrupt negotiations or operations within the scheme.

61. The same regulations included an easement to remove performance fees from the requirement to pro-rate charges under the charge cap for members who spent less than a full charges year in the scheme. Given removal of performance fees from the charge cap will mean such fees are no longer classed as "charges", performance fees will fall out of the overall requirement to pro-rate charges for part-year membership. This makes our previous pro-rating easement redundant and so we propose removing it from legislation.

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

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

Next steps

62. The Government will be introducing several initiatives to meet our commitment to shift the focus of DC schemes’ investment strategies away from cost and more towards overall value, including opening up private markets to DC savers.

63. If there are suggestions that you have on specific policies that could be introduced to meet this objective, we welcome suggestions.

64. Before making a decision on whether to proceed with this reform, we will consider the responses to this consultation. We greatly value the time you take to issue a formal response.

65. If we move to regulate to remove performance-based fees from the list of charges which are outside the scope of the charge cap, we would aim to consult on those draft regulations early next year. Any regulations would then be planned to come into force in October 2022.

Annex A

List of assumptions used in the modelling of worked examples demonstrating the potential impact of different performance fee structures

Assumptions	Assumptions	Private equity fund fee structure		
		2:20	**1:25**	**0:30**
Grow Pension DC Default Fund allocation	Starting fund value	£100m	£100m	£100m
	Allocation to private equity fund (%)	10%	10%	10%
	Allocation to other assets (%)	90%	90%	90%
Returns	Private equity fund	15%	15%	15%
		20%	20%	20%
	Other assets	8.5%	8.5%	8.5%
Fees	Private equity fund AUM fee	2%	1%	0%
	Private equity fund performance fee	20%	25%	30%
	Private equity fund hurdle	8%	8%	8%
	Other assets AUM fee	0.4%	0.4%	0.4%
Charge cap		0.75%	0.75%	0.75%