Department
for Work &
Pensions

Broadening the investment opportunities of defined contribution pension schemes

Response to Chapter 2 of the ‘Facilitating Investment in Illiquid assets’ consultation

Consultation on draft Disclose and Explain and Exempting Performance-based Fees from the Charge Cap regulations and statutory guidance

October 2022

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Introduction

About this consultation

Purpose of the consultation

This document includes the government's response to the March 2022 - Facilitating Investment in illiquid assets – chapter 2: introducing Disclose and Explain Policy proposals and consults on draft regulations and guidance to achieve the policy intent.

It also seeks your views on draft regulations and guidance on the exemption of performance-based fees from the regulatory charge cap proposals designed to stimulate illiquid investment by occupational Defined Contribution (DC) pension schemes.

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.
- any other interested stakeholders.

Scope of consultation

This consultation applies to England, Scotland and Wales.
Occupational pensions are a devolved matter for Northern Ireland, and we are working closely with counterparts in Northern Ireland at the Department for Communities in relation to the matters set out in this consultation.

Duration of the consultation

The consultation period begins on 6 October 2022 and will run until 10 November 2022.

How to respond to this consultation

Please send your consultation responses on the template provided via email to: DC Policy, Investment and Governance Team at the shared email address:
Email : PENSIONS.INVESTMENT@DWP.GOV.UK

Government response

We will aim to publish the government response to the consultation on draft regulations and statutory guidance on the GOV.UK website at the same time as or before we lay the regulations in Parliament, should we pursue regulatory reform of performance-based fees within the charge cap and disclose and explain rules.

How we consult

Consultation principles

This consultation is being conducted in line with the revised Cabinet Office consultation principles published in March 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), 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
Legislative Strategy Team
4th Floor, Caxton House
Tothill Street
London
SW1H 9NA
Email: caxtonhouse.legislation@dwp.gsi.gov.uk

Data Protection and Confidentiality

For this consultation, we will publish all responses except for those where the respondent indicates that they are an individual acting in a private capacity (e.g., a member of the public). All responses from organisations and individuals responding in a professional capacity will be published. We will remove email addresses and telephone numbers from these responses; but apart from this, we will publish them in full. For more information about what we do with personal data, you can read DWP's Personal Information Charter.

Ministerial Foreword

We are delighted to be publishing the government's response to the important consultation on 'facilitating investment in illiquid assets' we ran in March.

Enabling our occupational schemes to take advantage of long-term illiquid investment is one of this government's key priorities. With more members enrolling in defined contribution (DC) schemes thanks to the success of automatic enrolment, with the scale of assets invested in DC expected to double by 2030, and the emergence of collective money purchase (CMP) schemes this year, its right that trustees and managers now consider investing in a broader range of assets as part of a diversified portfolio. This includes in start-up companies, renewable projects and infrastructure that can offer potentially greater returns for pension savers building towards retirement and can have the added benefits of improving the UK economy and society.

Industry insight up to this point has been essential, and we welcome the broad support and constructive feedback we have received to the proposal to require schemes to state their policy on illiquid investment and to disclose their asset allocations. We are now inviting views on draft regulations and statutory guidance which seek to deliver this proposed policy. The direction is set, and I intend to legislate by spring 2023.

The draft regulations also include the proposed measure to enable trustees to exempt performance-based fees from their charge cap calculations where they feel this in their members best interests. Whilst we realise performance fees and their relation to the charge cap is not the sole challenge that DC and CMP schemes may face when looking to invest in certain illiquid asset classes, it does remove a potential barrier. Removal has the capability to help facilitate greater levels of investment in private markets, which may not have been previously considered.

The performance-based fee measure removes a barrier for trustees when considering whether or not to incur performance-based fees, if they believe the investment provides value for their members. It is intended to provide an opportunity for fund managers and DC schemes to work together to ensure investment products work, and in equal measure protect, the interests of members.

We have listened to industry and refined our policy in light of the feedback we received. We want to ensure that the regulatory burden is reasonable and proportionate whilst still retaining the wider benefits that changes in this area could bring. The proposed measures emphasise the key role that trustees of DC and CMP schemes, and their advisors, have in ensuring the impact of different investment arrangements on long-term outcomes are appropriately considered. The role which illiquid assets could play in improving pension outcomes for members should not be overlooked.

We look forward to your continued support.

Chloe Smith MP Secretary of State for the Department for Work and Pensions, and Alex Burghart MP Parliamentary Under Secretary for the Department for Work and Pensions

Chapter 1: Summary

1. This document is the government's response to 'Chapter 2: Introducing Disclose and Explain Policy Proposals' from the March 2022 consultation 'Facilitating Investment in Illiquid assets'[1].

2. The government's response to 'Chapter 3: Employer-related investments' from the March consultation was already published on 22 July 2022[2]. The relevant regulations will come into force on 01 October 2022.

3. Chapter 2 summarises and responds to stakeholder responses to our proposals to amend the Statement of Investment Principles (SIP) requirements to ensure that relevant defined contribution (DC) pension schemes disclose and explain their policies on illiquid investment, and for schemes with over £100 million of assets under management to disclose and explain the percentage of assets in the default funds allocated to different asset classes in their annual chair's statement.

4. The chapter concludes by seeking views on draft regulations and new statutory guidance which captures the policy intent. It also seeks views on the impact assessment which reflects the costs and benefits to business of these proposed measures.

5. Chapter 3 seeks views on proposed legislative changes to exempt performance-based fees from the regulatory charge cap used for automatic enrolment default funds. This follows on from the government response in Chapter 1 of the March consultation.

6. The policy proposals were first outlined in the November 2021 consultation 'Enabling investment in productive finance'[3] and have been developed further following the feedback we received to that consultation and further follow-up engagement that we have conducted with a range of industry stakeholders.

7. In August this year legislation came into force, allowing for the first time, single or connected employers to seek authorisation to operate their collective money purchase (CMP) schemes.[4] A notable feature of CMP schemes is that they are designed to provide an income in retirement, meaning there is greater opportunity for investment in a range of higher return seeking assets over a longer period than in traditional DC schemes. It is sensible therefore that the changes intended to facilitate and monitor investment in illiquid assets in DC schemes are also considered for CMP schemes. This position is reflected in our draft regulations and statutory guidance.

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[1] Facilitating investment in illiquid assets - GOV.UK (www.gov.uk)
[2] Response: Facilitating investment in illiquid assets by defined contribution pension schemes: Chapter 3 – Employer-related investments - GOV.UK (www.gov.uk)
[3] Enabling investment in productive finance - GOV.UK (www.gov.uk)
[4] Commonly referred to as collective defined contribution (CDC) schemes.

Chapter 2: ‘Disclose and Explain’ policies on illiquid investment

Background

8. It remains a priority for government to find ways to facilitate greater diversification in investment by UK institutional investors, particularly through investment in less liquid assets because of their potential to deliver higher long-term returns to savers as part of a diversified investment portfolio.

9. In ‘Chapter 2: Introducing Disclose and Explain Policy Proposals’ of the ‘Facilitating investment in illiquid assets’ consultation published in March 2022, we stated our intention to amend SIP requirements to ensure that relevant DC pension schemes disclose and explain their policies on illiquid investment.

10. We also proposed to introduce regulations that would require relevant DC schemes with over £100 million in assets under management (AUM) to publicly disclose and explain their default asset class allocation in their annual chair’s statement.

Current position

11. The key drivers of this policy are to encourage industry-wide transparency and standardised disclosure as well as greater public accountability for the investment decisions made by trustees on behalf of their automatically enrolled members.

12. Trustees of DC schemes are beginning to explore illiquid investment and it would be beneficial to other schemes, members, employers and regulators to understand their rationale behind choosing to invest (or not) in these asset classes. In a changing investment environment, we are following industry movement and evolution.

13. It is important to note that we are not requiring schemes to change their asset allocation under the proposed regulatory requirements, but rather to encourage them to reflect on the decisions they have already made, and the decisions they will make, as part of their ongoing fiduciary duty to create an investment approach that works in the best interests of their members.

14. The disclosure of schemes’ policies on illiquid investments and their asset allocations will improve the availability of investment information to members and employers and provide them with the certainty that schemes are providing members with the best possible value. It will also help to ensure that trustees are giving proper consideration to a wider range of investment opportunities on offer and allow trustees of schemes that may be considering illiquid investments, and

scheme's who've already invested, to compare the impact their respective asset allocations have on investment returns.

Overview of stakeholder responses

15. We received a total of 42 responses to Questions 1 to 9 in Chapter 2 of the 'Facilitating investment in illiquid assets' consultation. The responses came from a mix of organisations across industry, including from 13 trade associations / industry bodies; 9 trustee service bodies (advisers, actuaries, consultants, administrators, professional trustees, law firms and their representatives); 9 master trusts; 7 investment management firms and financial services representatives; 2 single employer trusts; and 2 not-for-profit professional organisations.

16. The majority of respondents to the consultation were supportive overall of the policy intent behind our proposals. Several respondents provided valuable suggestions as to how we could best meet our policy objectives whilst keeping the burden on trustees down and protecting members' best interests. These responses are summarised below.

Summary of Stakeholder responses

We asked: Do you support these proposals and agree with the government's rationale for intervention?

17. A significant majority of respondents were supportive of the government's rationale for intervention using the proposed regulatory changes. They agreed that increased transparency, comparability, standardisation and competition in the pensions industry should be supported by regulatory change.

    "[the disclosure proposals] are largely consistent with other disclosure requirements on trustees, the PLSA is open to supporting this additional transparency. As the paper sets out, not only does this provide an opportunity for members to engage with their pension, but it may also prompt consideration of illiquids investments by trustee boards." **The Pensions and Lifetime Savings Association**

18. Most respondents also agreed that further encouragement by government of trustees' consideration of investment in illiquid assets in DC default strategies is needed and could benefit members.

    "We strongly support these proposals and agree with the Government's rationale. We believe illiquid investments will play a critical role in improving DC savers'

retirement outcomes both in terms of additional returns and diversification benefits along with the additional scope it brings to engage DC members with how their pensions are invested.” **Cushon Group**

19. They also agreed that the proposals would help further the government’s attempts to encourage a refocusing of the occupational pensions industry attention away from primarily considering cost.

    “We believe that the government's proposals will progress developments in adopting an overall value for money approach, moving away from an isolated consideration of costs alone – which can only be to members' advantage.” **Partners Group**

20. Some respondents agreed these new requirements could also help members to better understand the value of the investments being made for them.

Government Response

21. We are pleased to have received broad support for our proposals and the rationale that underpins them. These proposed regulatory changes, alongside other advancements being made by both government and industry, will begin to encourage more debate and consideration of alternative investment strategies by trustees, when it is in the best interests of their members.

22. We expect transparency around investment decisions and comparability across pension schemes will increase as a result of these proposed regulatory changes, allowing for a keener focus across the pensions industry on delivering value for money for members.

Amendments to the SIP

We asked: Do you agree with the scope of this proposal? Considering the policy objective to require trustees to state a policy on investment in illiquids, how should we define “illiquid assets”? Do you agree with the proposed aspects of a scheme’s illiquid asset policy that we would require to be disclosed and timing of such disclosures?

Scope

23. The majority of respondents agreed with the scope of the proposal to amend the SIP, stating that it was appropriate to require this disclosure to relate to the default arrangements of relevant occupational DC schemes only, excluding self-select funds, as most members are invested in the default arrangement, and

excluding Defined Benefit (DB) schemes as those schemes are increasingly closing and de-risking, and already show a long precedent of illiquid investment.

“We agree that this proposal should directly apply to the default arrangements of Occupational DC schemes only.” **M&G**

24. A small minority of respondents argued that although the DB market structure is significantly different to DC, for the sake of transparency and comparability, DB schemes should also be in scope of the requirements.

“We agree with the proposal to require DC schemes to include an explanatory statement on their policy towards investment in illiquid assets in their triennial SIPs. We are less convinced by the suggestion that defined benefit (DB) schemes should not be required to set out their policy towards investment in illiquid assets.” **John Forbes Consulting LLP**

25. A few respondents made the case that self-select funds should be within scope of this policy as they considered it is often easier to introduce illiquid investment to members through self-selection for a variety of reasons, notwithstanding the lesser constraints on permissible member charges.

“We would however be open to the disclosures being required to cover self-select funds rather than focusing on default arrangements. It can be “easier” to introduce illiquid assets as part of a self-select range (owing to there being fewer constraints on charges), and trustees being prompted to consider this may allow confidence to be built on such options in advance of future incorporation in a default arrangement.” **Association of Consulting Actuaries Limited**

26. A few respondents suggested there should be a threshold for the new SIP requirements.

“… we suggest that consideration is given to adding a threshold based on scheme assets, below which schemes do not have to include the explanatory statement about investment in illiquid assets. This is because it tends to be relatively large schemes which invest in illiquid assets and therefore producing such a statement will not be meaningful for smaller schemes. We suggest the threshold should be set at £250m - £500m…” **The Pensions Management Institute**

27. A few respondents were concerned the proposal would prompt a disproportionate focus on inclusion of illiquid assets over other asset classes in default arrangements.

“By including a specific requirement to disclose their policy on illiquid assets, there is a risk that trustees will unduly focus on this asset class over other assets, which may not be in the best financial interests of beneficiaries.” **Association of Pension Lawyers**

28. Some respondents also questioned whether the requirement would only cover the “main” default arrangement or whether “unintended”/ “technical” defaults would also be in scope.

“Illiquid assets” definition

29. We asked stakeholders for their input in creating a standardised definition of the term “illiquid assets” to apply to the new illiquid investment policy disclosures in the SIP. We laid out the two following options for a proposed definition and asked for responses as to which would be most appropriate:

    - **Option 1:** Illiquid assets could be defined at the fund/vehicle level. Schemes use a range of different vehicles to invest in illiquid assets. Some of these vehicles are in effect liquid i.e. they (or shares in them) can be traded frequently and sold with ease despite investing in illiquid assets. We could specify that, given almost all DC scheme investment is done indirectly, illiquid funds or illiquid vehicles are the more appropriate subsection of investment options to hold a policy on. Funds could be deemed as illiquid once they reach a certain percentage threshold of their allocation being illiquid.
    - **Option 2:** Illiquid assets could be defined at the more granular asset level. If the investment itself is not able to be sold frequently, perhaps daily, this could be counted as an illiquid asset no matter the investment vehicle through which this is disclosed. This could be done by listing asset classes that are considered illiquid. This would require a scheme to ‘look-through’, for example, a multi-asset fund to understand the allocation within a particular fund.

30. The majority of respondents thought that ‘Option 2’ was most appropriate for defining illiquid assets in accordance with the policy proposal.

    “Of the two options presented, our preference would be Option 2. This provides more transparency, a more accurate picture and may be easier for schemes to implement.” **The Investing and Saving Alliance**

31. Many respondents stated that Option 2 best fitted with our proposed policy intention of keeping the scope of the definition of “illiquid assets” as wide as possible to ensure that innovation in investment is protected and all forms of illiquid assets are captured.

    “We have a preference for Option 2. This, in our view, will provide the greatest scope for innovation of solutions to incorporate less liquid assets in portfolios … Option 2 provides the added benefit that the ‘look through’, for example, in multi-asset funds which may be a legitimate approach for accessing illiquid assets by smaller schemes. Option 2 also enhances transparency and provides greater scope for trustees to evaluate the value provided from illiquid assets in our view.” **Hymans Robertson**

32. A few respondents said they preferred ‘Option 1’ because they believe trustees tend to make investment decisions at the fund-level and a higher-level definition could be easier for trustees to implement and members to understand.

"Option 1 (defining illiquids at the fund/vehicle level) will be more straight forward for DC schemes to implement." **State Street Global Advisors**

33. A few respondents questioned the need to define illiquid assets at all and considered it unlikely that a correct and productive definition could be achieved.

"… we are doubtful that it is possible to have a precise definition … The risk of attempting to precisely define illiquid assets in regulation is that it creates a sense of 'approved' asset classes and does not allow for the development of new asset classes over time." **The Investment Association**

34. Some respondents suggested that the definition should be left for trustees of schemes to determine, so they can designate certain assets as "illiquid" as they see appropriate.

"... we would support a definition based on a common-sense approach in which Trustees designate the assets that they deem to be illiquid…whilst this approach may sacrifice consistency, it would allow Trustees to retain more flexibility and discretion in fashioning an investment strategy. Moreover, this type of approach would still meet the policy goal of facilitating greater consideration of illiquid investments by Trustees." **Nest**

35. Some respondents pointed out the costs which may arise from implementing a definition aligned to 'Option 2'.

"This level of definition of "illiquid assets" would add a significant additional cost and reporting burden on schemes and there is a risk that SIP reporting becomes even more convoluted and detailed." **Association of Pension Lawyers**

36. Some respondents argued that the definition of illiquid assets should be linked to the frequency that a specific asset is able to be valued or sold.

Disclosure aspects and timing

37. The majority of respondents agreed with the proposed aspects of a scheme's illiquid asset policies to be disclosed and the timings of these disclosures.

38. Respondents specifically agreed with mirroring the current requirement to review a SIP every three years and/or where there is significant change in investment policy.

"We believe the proposed aspects are both practical and proportionate and will enable trustees to tie this in with existing SIP review and publication requirements. We also agree that a scheme's approach to illiquid investments is unlikely to change more frequently than at least every three years." **Legal & General**

39. Some respondents noted that the expectations of resources and time required in producing the illiquid assets policy statement, as envisaged in the consultation,

were over optimistic and that the burden on trustees to create these policies might not outweigh the value of the disclosures.

"…we think the proposals for a scheme's illiquid asset policy would require significant additional disclosure in the SIP and we do not consider the disclosure costs (and time) to be proportionate" **Eversheds Sutherland**

40. A few respondents stated that the proposals only applying to the default arrangements could mean aspects of the SIP disclosure are unnecessary since members in default arrangements are less likely to engage with their SIP.

"…since the proposals only apply for the *default* arrangement, this is by definition going to be for members who don't want to make any decisions. Few of our members read the SIP … We do not believe that including an illiquid asset policy with all the information listed in paragraph 98 is an effective way of communicating and indeed educating members on investment arrangements." **HSBC**

41. A few respondents agreed with the proposals but noted that the aspects listed might be too prescriptive and that government should perhaps make the disclosure requirements more high-level to lessen the burden on trustees.

"We agree with the proposals, but consider that it is going too far for trustees to be required to disclose what factors they consider when deciding whether to invest in these assets; any current barriers to investment in illiquid asset; and any future plans for investment in illiquid assets. This level of detail in respect of policy decisions seems unnecessary, and increases the risk of members bringing a claim against the trustees." **Pinsent Masons LLP**

42. Several respondents suggested there should be a delay between the SIP disclosure requirement coming into force and when schemes are first required to add the disclosures to their SIP.

"… it should be noted that the policy proposals will take time to be implemented and included in the SIP. Trustees will require training on illiquid assets and over the course of a few meetings (usually only quarterly in nature), will define their policy on illiquid assets." **CFA UK**

43. Some respondents suggested that there should be a deadline for the first SIP disclosure so that the first disclosures are made around a similar time period.

"….there should be a set deadline for when the initial disclosure should be made by which all relevant schemes must adhere to … which can then be updated triennially. This would really focus the industry on thinking about illiquids at the same time and speed up the transition rather than allow schemes up to 3 years to come up with a policy individually." **Scottish Widows**

Government Response

44. We initially proposed to add a requirement concerning the illiquid asset policy to regulation 2(3) of The Occupational Pension Schemes (Investment) Regulations 2005[5]. However, after reflecting on responses to the consultation and further discussion with legal industry stakeholders, we now propose to instead add the requirement to regulation 2A, as this applies to the Default SIP where the scope of schemes captured, and location of the proposed disclosures align with the policy intent. For CMP schemes, which do not have a default SIP, we propose that the policies are included in the main SIP.

45. Reflecting the broad support for Option 2, we propose the following definition of 'illiquid assets': *"assets which cannot easily or quickly be sold or exchanged for cash and, where assets are invested in a collective investment scheme, includes any such assets held by the collective investment scheme".*

46. As requested by many respondents to the consultation, this definition seeks to ensure greater transparency, remain as high-level as possible so its easier to understand, cover as many types of current illiquid assets as possible, and to leave room for further industry innovation. However, we do propose some prescription in order to ensure that disclosures are consistent across all relevant schemes. We propose to require trustees to look through multi-asset investments to underlying investments, aligned with Option 2 above, so that all illiquid exposures are clearly covered in disclosures and all schemes calculate their asset allocations at asset-level rather than fund-level.

47. We decided not to use daily dealing or valuation as a key part of the definition of "illiquid assets" as only a very few respondents believed it would be appropriate to do so. Furthermore, there are illiquid assets that can be dealt daily as part of multi-asset funds as well as liquid assets that sometimes are unable to be sold quickly. We would also like to move away from the notion that a lack of daily dealing is a barrier to investment by occupational pension schemes. Pensions are long-term investments by nature and there is often little movement in or out of a scheme until an individual is nearing retirement. Some assets that cannot provide daily dealing could be providing members with better net returns within a diversified portfolio.

48. We have considered suggestions from respondents as to which of the proposals were too burdensome or prescriptive for trustees to adhere to and have consequently slimmed down the proposed aspects of a scheme's policy on illiquid investment required to be disclosed. We also plan to produce guidance relating to SIPs in due course.

49. We have listened to stakeholders concerning their position on when schemes should update their Default SIP with these new requirements for the first time. We propose that the new requirements should apply on the first occasion when the Default SIP, or main SIP for CMP schemes, is updated after 01 October 2023, with a requirement that the policy on illiquid assets must be included in all Default

[5] The Occupational Pension Schemes (Investment) Regulations 2005 (legislation.gov.uk)

SIPs, and main SIP for CMP schemes, from 01 October 2024. We believe this will ensure that schemes are giving full consideration to their policy on illiquid investment in a timely manner.

Asset allocation disclosure

We asked: Do you agree with the proposed level of granularity for this disclosure? Are the asset classes and sub-asset classes proposed in the example above appropriate for this kind of asset allocation disclosure? Do you agree that holding £100 million or more of total assets is an appropriate threshold for determining which DC schemes should be required to disclose asset allocation? Do you agree that we should align the disclosures with the net returns' disclosure requirement? Do you agree with the frequency and location of the proposed asset allocation disclosures?

Granularity of disclosure

50. The majority of respondents agreed with the proposed level of granularity with a general consensus that the asset classes and sub-asset classes proposed would help to increase transparency, standardisation and member engagement.

    "… we agree with the proposed level of granularity for the asset allocation disclosure and the proposed sub-asset classes. We consider this information to be a minimum level of transparency that should be available to scheme members over the composition of their portfolio." **The Investment Association**

51. Several respondents highlighted that some schemes already produce and publish this data but that this level of granularity in regulation would allow for real consistency in disclosure across the occupational pensions market.

    "This approach provides additional consistency and transparency without overburdening the market … the degree of granularity recommended in the consultation strikes the right balance." **techUK**

52. Some respondents argued that any level of granularity, but especially the inclusion of sub-asset classes, is unlikely to engage or be understood by members.

    "We are not convinced that members will be interested in, or understand, this level of granularity … the chair's statement is rarely, if ever, read by the

members. In addition, there is a very low understanding that pensions are investments. More education is needed here first.” **Aegon**

53. Some respondents highlighted the need for clear guidance and definitions from government to make sure that asset allocation disclosures can be truly consistent across industry and any potentially overlapping asset classes can be clearly distinguished by all schemes in a uniform way.

    “We support greater transparency but note that very specific definitions would be required to get consistency across schemes as there may be some ambiguity in how to define asset classes such as property/infrastructure.” **Tesco**

54. Several respondents expressed concern that adding more granular disclosures to the chair’s statement would increase the length and complexity of these documents, against the best interests of members.

    “We do not believe that this serves member’s interests. A high-level overview of the general structure of the default is likely to be more understandable by members.” **The Pensions Management Institute**

Threshold

55. Some respondents agreed with the proposed £100 million AUM threshold for asset allocation disclosure in the context of what government has set recently in relation to smaller schemes required to undertake the enhanced value for member test and our proposal that those schemes could be exempt from this requirement to reduce burden.

    “… we agree that this is an appropriate threshold as it is consistent with the threshold for schemes currently in place to consider consolidation if they are not able to deliver value for members.” **Legal & General**

56. Although, some of these respondents also acknowledged that having £100 million as the decisive barrier is somewhat arbitrary.

    “This is an arbitrary threshold but we do recognise the convenience of setting it at the same level and on the same basis as the threshold as determining whether a scheme has to comply with the VFM comparison requirements you refer to.” **Lane Clark & Peacock**

57. A couple of respondents suggested that the threshold should be higher than £100 million AUM.

58. However, a significant number of respondents disagreed that there should be any threshold and thought that all DC schemes should have to make this information freely available.

    “…all DC schemes should be required to disclose their asset allocation. It is not clear why members of smaller schemes deserve less transparency over their portfolios than members of larger schemes. Nor do we consider this a burdensome requirement for any scheme: the information can easily be obtained

at the level of granularity proposed by the DWP from product disclosures made available by DC platforms and investment managers." **The Investment Association**

59. Some respondents made the case that removing the threshold for the asset allocation disclosure requirement could allow for the disclosures to be a useful tool for smaller schemes as part of their ongoing value for member assessments.

"Whilst we recognise the cost and governance burden that the proposals would bring, our preference would be for all schemes to be in scope, rather than limiting the new transparency to larger schemes. This may also be a further tool to prompt smaller schemes to consider consolidation options." **Association of Consulting Actuaries Limited**

Age-related disclosure

60. The majority of respondents agreed with the proposal to use age specific data disclosures for members aged 25, 45, and 55, which would be in line with the recommended approach government set out to the reporting of net investment returns for DC schemes default arrangement(s)[6].

"We completely agree that aligning to age is far more relevant than years before retirement. Nobody designing a scheme will be aware of when individuals might retire and so age is a far better proxy than an arbitrary retirement age." **Hargreaves Lansdown**

61. Some respondents that agreed with taking an age specific approach further suggested the value of having an extra age category to capture the de-risking that takes place between the age of 55 and retirement.

""We … suggest inclusion of a further saver age at the end of the accumulation phase since the asset allocation at this point is likely to be significantly different to that which applies for a saver aged 55. We would recommend that the additional age category be set at 65." **CFA UK**

62. Only a minority of respondents disagreed with the proposal to require age specific disclosures. Their preference was having a 'years from retirement' approach instead, especially for schemes using a Target Retirement Age investment strategy.

"We also think that for schemes operating target date funds, it would be appropriate to use "years from retirement" as a means of disclosure but we accept this does not align with the Government's drive for uniformity." **Association of Pension Lawyers**

63. Some respondents that preferred the years from retirement approach did also acknowledge the benefits that age specific disclosure could bring – such as a

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[6] Completing the annual Value for Members assessment and Reporting of Net Investment Returns - GOV.UK (www.gov.uk)

consistent approach to disclosure – and the fact that the two approaches are not too dissimilar, and neither should overly burden trustees.

"We believe that time to retirement would be the optimal approach for showing the variation in asset allocation over time….however, we recognise that harmonising asset allocation disclosures with the net returns' disclosure requirements around age cohorts will be easier for schemes, and this may be a more pragmatic approach. In any case we would not expect age-related disclosures to differ too widely from an approach based on time to retirement." **The Investment Association**

64. Some respondents advocated for leaving schemes to decide which type of disclosure they choose to use.

Frequency and location of disclosure

65. The majority of respondents agreed that asset allocation disclosure should be required annually in the chair's statement.

"We agree with the frequency and location of the proposed asset allocation disclosures in their alignment with the existing DC Chair's Statement." **XPS Pensions Group**

66. However, a few respondents noted a concern that the proposals signalled mandating averaging of the allocation figures and argued strongly against this.

"We do not see the value of the additional governance costs that would be incurred by the scheme to provide an average allocation figure, which by definition will not reflect the actual allocation of the fund at the time of reporting. Changes of quite different proportions could have the same average." **Aon**

67. Some respondents disagreed with adding further requirements to the chair's statement due to low member engagement with the increasingly complicated document.

"We see limited rationale for requiring schemes to disclose their asset allocation in the Chair's Statement as this information is already available to members (e.g. in factsheets) and the requirements of the Chair's Statement are already onerous." **Isio Group**

Government Response

68. After consideration of the responses, we propose to only require the highest level of granularity to be used in asset allocations disclosures. Numerous respondents argued that disclosure with a higher level of granularity is more likely to be at a level that members can understand, and trustees can more easily implement. However, we propose putting more detailed explanations and suggestions of sub-asset classes that could also form part of these disclosures in the statutory

guidance. This will enable trustees to decide what level of granularity is most appropriate for their members without compromising industry standardisation.

69. Most respondents called for clear guidance and definitions to be provided by government so that asset allocation disclosure requirements can be truly standardised and comparable, without too great a burden falling on trustees. We have therefore published draft statutory guidance alongside the draft regulations so that trustees can more easily understand the new proposed requirements and what the disclosures should look like in reality.

70. We have decided to remove the £100m threshold to ensure all schemes, regardless of size would be captured by our proposed requirements. This change in the policy intent supports greater transparency in investment decisions and increased consistency in disclosure across the DC industry and can be used as a tool for comparison of value between schemes.

71. We have noted stakeholders' suggestions that there should be an age category closer to retirement age than 55. We have therefore decided to introduce another category "1 day prior to State Pension Age" in the draft statutory guidance. An age specific approach is not expected in CMP schemes given their collective nature.

72. Many respondents requested flexibility and reduced prescription in the requirements relating to how trustees should structure an asset allocation disclosure. We have therefore set out a recommended approach for how schemes could present their asset allocation in the draft statutory guidance, in the interests of providing a consistent and standardised approach. However, this is not proposed to be a requirement, with schemes ultimately being able to decide themselves how they would like to best present this data to their members.

73. In light of responses to the consultation, which demonstrated the unnecessary burden that averaging could put on schemes, we have decided not to propose that this be a requirement. However, the averaging method is still recommended and explained in the draft statutory guidance for schemes that wish to use it, especially if their asset allocation has fluctuated or been altered significantly across the year.

74. We recognise the concerns some stakeholders raised about the suitability of the chair's statement for these disclosures. In April 2021, the Department published its conclusions from the statutory post implementation review (PIR) of the chair's statement provisions, namely Part V of the Occupational Pension Schemes (Scheme Administration) Regulations 1996.

75. We have begun engaging with industry representatives and the Pensions Regulator to consider how best to address issues that currently exist with the chair's statement. We will be using the forthcoming Value for Money Framework consultation to better understand how the chair's Statement should interact and fit with the VFM Framework moving forward.

Impacts

We asked:
Please provide estimates of any new financial costs that could arise from the proposed “disclose and explain” requirements. Please outline any one-off and ongoing costs.

76. A number of respondents stated they did not believe any material costs would arise from the proposed requirements. This included pension schemes and asset managers.

    “We believe the additional costs involved will be negligible” **Cushon**

    "This is difficult to estimate, although we do not expect the cost or burden to be prohibitive” **Smart Pension**

77. The majority of responses described one-off and ongoing financial costs to trustees and pension schemes that may arise from the proposals. These referenced the following types of activities:

    - One-off cost to trustees for necessary training on illiquid asset investment.
    - One-off cost to trustees to familiarise themselves with and understand the new requirements.
    - One-off cost to pension schemes from seeking legal advice to ensure schemes are meeting regulatory requirements.
    - One-off cost to pension schemes to produce an explanatory statement on their policy towards investment in illiquid assets and an ongoing cost from updating the statement when required.
    - One-off cost to pension schemes to produce asset allocation breakdowns and an ongoing cost from updating this data when required.

78. Some respondents stated there would be a new, one-off financial cost for trustee training on investment in illiquid assets.

    “Each scheme will need to consider the costs of training for trustees” **CFA UK**

79. A minority of respondents highlighted schemes may experience an additional, one-off cost from seeking legal advice in the first year of the policy to ensure they are fulfilling the regulatory requirements. Estimates provided for this cost ranged from £3,000 to £5,000 per scheme.

    “We note that in the first year trustees may wish for a more detailed review from their legal or auditor teams or through working with consultancies.” **Mercer**

80. One respondent raised the new financial cost to trustees associated with understanding the new regulatory requirements.

"Broadly speaking the costs to trustees will be associated with […] understanding the new requirements" **ACA**

81. Several respondents raised new additional one-off costs to pension schemes from producing their explanatory statement towards investment in illiquid assets and the ongoing cost of updating this statement when required.

"Costs would include additional time for the trustees to discuss and prepare their policy, and support from providers and their advisers." **Aegon**

82. Several respondents raised new additional one-off costs to pension schemes from producing average asset allocation breakdowns and updating these when required.

"Broadly speaking the cost to trustees will be associated with […] additional data gathering, additional time spent checking investment manager information for consistency, more time spent preparing the Chair's statement (already a substantial process), time aligning the format with other member communications" **ACA**

83. Estimates provided for one-off costs for producing an explanatory statement and average asset allocations ranged from £2,000 to £10,000 per scheme. Estimates provided for ongoing costs for updating an explanatory statement and average asset allocations ranged from £1,000 to £2,000 per scheme per year.

84. Only a few respondents mentioned a risk that additional costs to pension schemes from the proposed requirements may ultimately be passed onto members.

"[…] the increasing costs of meeting the various disclosure requirements on pension schemes, as any significant costs could end up being passed onto scheme members" **PLSA**

85. One respondent raised concerns about the impact of proposals on small pension schemes.

"It should also be noted that smaller schemes will bear a relatively high burden of the financial costs of these changes. For these schemes, the changes are likely to be resource intensive and require substantial consultant input, resulting in much higher financial costs" **CFA UK**

Government Response

86. The responses to this question provided valuable feedback and insight. There were a number of helpful points raised which we have considered in the impact assessment and responded to below.

87. **Training costs** – We consider understanding of illiquid asset investment to be included in trustees' fiduciary duty. We have therefore not included any training costs to trustees as a separate cost to the one-off costs in year 1.

88. **Legal costs** – The regulations do not require schemes to seek legal advice to ensure they are fulfilling the regulatory requirement. This would be voluntary. Therefore, we have not included in the costs to business.

89. **Familiarisation cost** – Trustees will experience a one-off familiarisation cost from time spent reading and understanding the new regulations. We have accounted for this cost in the impact assessment.

90. **Cost of producing and updating the explanatory statement** – Pension schemes in scope will experience a cost from producing an explanatory statement on their policy towards investment in illiquid assets and updating their SIP with new information every three years. We have accounted for these new one-off and ongoing costs in the impact assessment.

91. **Cost of producing and updating asset allocation disclosures** - Pension schemes in scope will experience a cost from producing asset allocation information and breakdowns and updating the chair's statement with new asset allocation information and breakdowns annually. We have accounted for these new one-off and ongoing costs in the impact assessment.

92. **Impact on members** – Three respondents raised the possibility of additional costs being passed onto members. Although additional costs could be passed on to members, the overall cost is expected to be low. We believe the policy could benefit members through having greater access to information and greater understanding of how their pension fund is being invested.

93. **Impact on small schemes** – The scope of the proposed amendments of the SIP and chair's statement regulations is consistent with existing SIP and chair's statement rules i.e., relevant occupational DC pension schemes with 100 or more members. Therefore, we do not expect small pension schemes will be excessively impacted by these proposals.

Proposed changes to regulations and commentary

94. This section summarises the regulatory changes related to our 'Disclose and Explain' proposals that we are looking to introduce through the draft Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2023 (the "2023 Regulations").

95. The 2023 Regulations amend the following regulations in relation to the 'Disclose and Explain' proposals.

    - the Occupational Pension Schemes (Investment) Regulations 2005[7] ("Investment Regulations").

[7] The Occupational Pension Schemes (Investment) Regulations 2005 (legislation.gov.uk)

- the Occupational Pension Schemes (Scheme Administration) Regulations 1996[8] ("Scheme Administration Regulations")
- the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013[9] ("Disclosure Regulations")

Regulation 1 – commencement and application of the proposed changes

96. Regulation 1 explains when the new requirements would apply to schemes. Regulation 1(5) proposes that relevant occupational pension schemes will be required to action the new asset allocation disclosure requirements in their chair's statement for the first scheme year which ends after 1 October 2023.

97. Regulation 1(8) proposes that the new illiquid investment policy disclosures will be required to be added to the first Default SIP of relevant occupational pension schemes published after 1 October 2023 and at the latest by 1 October 2024.

Regulation 3 – amending the Investment Regulations

98. Regulation 3 proposes to amend Regulation 2A of the Investment Regulations to require relevant occupational pension schemes to include an explanation of their policies on investing in illiquid assets in their Default SIP.

99. Regulation 3(2)(c) sets out the proposed aspects of a scheme's policy on illiquid investments that this regulation would require trustees to disclose. These aspects have been chosen after discussion and collaboration with industry stakeholders and responses to past consultations. They aim to find a balance between prescription so that disclosures are standardised, and therefore comparable, but also high-level enough that relevant schemes are not too burdened and have the ability to mould the disclosures to fit the design of their schemes and the best interests of their members.

100. Regulation 3(2)(d) sets out our proposed definition of "illiquid assets" as "assets which cannot easily or quickly be sold or exchanged for cash and, where assets are invested in a collective investment scheme, includes any such assets held by the collective investment scheme". The definition aims to be high-level enough so that industry may continue to innovate, and all current illiquid assets are covered by the definition, but prescriptive enough so that disclosures are uniform across all relevant schemes.

101. Regulation 3(3) proposes to insert Regulation 2B into the Investment Regulations to require qualifying CMP schemes to include an explanation of their policies on investing in illiquid assets in their SIP.

Regulation 4 – amending the Scheme Administration Regulations

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[8] The Occupational Pension Schemes (Scheme Administration) Regulations 1996 (legislation.gov.uk)

[9] The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (legislation.gov.uk)

102. Regulation 4(5) proposes to insert Regulation 25A into the Scheme Administration Regulations to require trustees or managers of occupational defined contribution schemes to report in their annual chair's statement on the percentage of relevant scheme assets allocated to different asset classes within their default arrangement.

103. New regulation 25A(3), inserted by regulation 4(5) proposes the main asset classes for which the allocation would be required to be disclosed by all relevant schemes. These main asset classes have been determined through discussions and collaboration with industry stakeholders and past consultations.

104. New regulation 25A(4) sets out that trustees or managers of the scheme would have to have regard to any statutory guidance produced that accompanies these regulations.

105. New regulation 25A(5) proposes that when a scheme is invested in a collective investment scheme, the underlying assets held by the collective investment scheme are what must be referred to when making any asset allocation calculations. Advice we received from our engagement with industry stakeholders and from previous consultations indicated that the regulations should require schemes to look-through a multi-asset investment to the underlying assets held, otherwise indirect allocation to certain asset classes would be easily overlooked.

Regulation 5 – amending the Disclosure Regulations

106. Regulation 5 proposes to amend regulation 29A of the Disclosure Regulations to require trustees or managers of schemes in scope to publish the section of the chair's statement which covers the new disclosures about asset allocation.

107. Publication of default asset allocation data will be an important step towards transparency, standardisation of disclosure, and comparability across the DC pensions market. It is important that members have access to all relevant information surrounding the investments being made using their contributions and the outcomes these investments could have on their future retirement funds. Public disclosure would also enable trustees, employers and members to compare the value for money differing asset allocations bring to members when read alongside the net returns also published in the chair's statement.

Question 1: Do you have any comments on the draft regulations in relation to the disclose and explain provisions? Please include in your answer any comments on whether you consider they meet the stated policy intent.

Question 2: Are there other elements not covered in these regulations that you would expect to see?

Draft statutory guidance

108. The draft statutory guidance sets out guidance in relation to the proposed regulatory asset allocation disclosure requirements. It aims to ensure that trustees have a comprehensive understanding of the aspects of the asset allocation disclosure that are expected and suggested by government, including definitions of different asset classes and how the data should be presented to members.

109. Many respondents to our 'disclose and explain' proposals asked for clear guidance and definitions to be provided by government if/when asset allocation disclosure requirements come into force. This guidance aims to fulfil these requests and ensure that trustees are supported in the creation of their disclosures.

110. The draft statutory guidance clearly sets out the drivers and scope of the policy so that trustees may understand whether or not their scheme must publish these disclosures, and why. It also sets out specific definitions for all the required asset classes to be included in the disclosure so that when calculating allocations, there is no confusion as to which asset class a particular asset should be classified as.

111. Proposed sub-asset classes that trustees may want to voluntarily include in their disclosures are included in the guidance. This is to give members a more precise understanding as to the investments being made on their behalf. It focuses on the importance of the regulatory requirement to look-through multi-asset investments to the underlying assets to understand the exact allocation of a default arrangement and make sure that certain types of investment are not lost by disclosures that only focus on fund-level asset classes.

112. Finally, the draft statutory guidance also includes examples of how government suggests asset allocation disclosures should be presented to members. This consists of a table with percentage allocation to the main asset classes split between age groups across different stages of accumulation, as well as a clear graph for each of those age groups to engage members more easily.

Question 3a: Do you have any comments on the proposed regulatory asset allocation disclosure requirements included in the draft statutory guidance?

Question 3b: Are there any areas where further clarity might be required?

Impact Assessment - Costs and Benefits

113. A draft impact assessment considering the direct and indirect financial impacts on business and on others has been published alongside this consultation.

114. We welcome any evidenced comments on the impact assessment.

Question 4: Do you agree with the information presented in the impact assessment?

Question 5: Do you have any comments on the impact of our 'disclose and explain' proposals on protected groups and how any negative effects may be mitigated?

Chapter 3: ‘Exempting performance-based fees from the regulatory charge cap’ draft regulations and statutory guidance

Background

115. Our November 2021 consultation ‘Enabling investment in productive finance’ made the case that adding performance-related fees to the list of charges that can be considered outside the scope of the regulatory charge cap limit of 0.75% that applies to the default funds of occupational pension schemes used for automatic enrolment, could provide more opportunities for schemes to access a more diverse range of asset classes for the financial benefit of their members.

116. It would allow schemes the option to incur well-designed performance-based fees that are paid when a fund/asset manager exceeds pre-determined performance targets, in the knowledge that those fees would not be subject to the cap. The intention being that schemes should only pay such fees when genuine performance is achieved. The exemption would therefore not apply to fees that are not related to performance. For example, any annual fixed management fee or other costs that are often applied to performance fees.

117. We also proposed that any performance-based fees would need to be disclosed and assessed as offering value to members in the scheme’s annual chair’s statement. This was necessary to ensure full transparency of what fees are paid to fund managers and why.

118. In chapter 1 of the March 2022 consultation ‘Facilitating investment in illiquid assets’ we summarised the feedback we had received to the proposal. Whilst the financial services sector and some pension providers welcomed the proposal as a positive step to removing a barrier that could see DC pension schemes access private markets in greater numbers, other pension providers, trustee service and legal advisory bodies were not convinced. Some saw the proposal as potentially diluting the charge cap, successful since its introduction in ensuring member charges remain low. Others cited the proposal, whilst potentially removing a barrier, would not be enough to incentivise trustees of DC schemes to increase investment in illiquid assets.

119. As a result, we agreed to conduct further engagement with a range of stakeholders on the design of the policy. This involved listening to concerns and suggestions as to how the policy could be strengthened so that schemes and

members could be safeguarded, without the protection of the charge cap, from predatory fees in cases of poor performance.

120. This chapter summarises the work that we have undertaken since and seeks views on draft regulations and proposed statutory guidance which are intended to support trustees of DC schemes that want to explore investing in a wider range of assets, including those that are typically offered with performance fee structures.

Current position

121. Ten years on from the introduction of automatic enrolment, there are around 11 million active savers in UK DC schemes. Assets managed by these schemes have increased rapidly over this time and are expected to grow significantly over the next 5 to 10 years with new contribution income and fund growth. As DC schemes grow in scale and capability, their access to a range of investment opportunities, including access to illiquid asset classes e.g. infrastructure, private equity and venture capital that could offer the potential of longer-term higher returns, will also increase.

122. The Pension Charges Survey 2020[10] showed two-thirds of DC schemes had no direct investment in illiquid assets in their default funds. We believe, as the DC pensions schemes continue to grow and mature, increasingly trustees will want to broaden their range of investment opportunities they consider given the potential benefits some of these investments may offer to their members.

123. We are seeking to ensure there are no obvious structural barriers now or in the future that would limit or disadvantage the ability of trustees of DC schemes to consider those investments. One such barrier that we want to remove is the role that performance fees and their interaction with the charge cap may play in limiting trustees' investment decision-making when it comes to illiquid assets.

124. We recognise that performance fees are not the sole challenge trustees of DC pension schemes face when trying to diversify their investment portfolios to include illiquid assets. There is also consideration of range and quality of available products, in addition to barriers posed by platform capabilities, asset pricing, and liquidity barriers, as well as matters of scale, additional governance burden and expertise. These points and others came out in the series of meetings we have held with stakeholders since March.

125. At the same time, feedback from stakeholders suggests none of these challenges are insurmountable. New regulated investment vehicles, such as the Long-term Asset Fund (LTAF) - a new open ended fund structure authorised by the FCA that allows wider access to assets such as infrastructure and private companies which are not regularly traded **-** and other new products or vehicles are starting to emerge that will be attractive propositions to DC pension schemes. The LTAF is subject to specific rules tailored to investment in illiquid assets. We believe these and the more progressive nature of the DC market will drive change, remove

[10] Pension charges survey 2020: charges in defined contribution pension schemes - GOV.UK (www.gov.uk)

other barriers, and ultimately open up greater opportunities for institutional investment.

126. Although not the sole barrier, performance fees can discourage many trustees from considering investments that would require them to allocate otherwise unused charge cap 'headroom' to such payments. Adding performance-based fees where the members only pay fees when they have received a net return on their investments to the list of charges outside the scope of the cap, could be an important enabler now, and in the future, as the DC market continues to grow, gains scale and considers investing in a broader range of investment opportunities. Equally, the option to utilise performance fees should also be considered by CMP schemes.

127. To be clear, both types of schemes are under no obligation to enter into arrangements where the investment comes with a performance fee if this does not fit with their investment strategies, or the arrangement is not in their members best interests. We acknowledge that some schemes have publicly stated that they will not pay performance fees of any kind and we expect some investment opportunities to arise where schemes can invest in a broader range of investment opportunities without turning to investments that come with performance fees.

128. The draft Regulations are not intended to reduce the bargaining power of DC schemes to demand alternatives to performance fees. Instead, we are seeking to ensure there is open dialogue between the trustees and the fund manager on appropriateness of the performance related fee structure and on the potential value the fee structure and the underlying investments may offer to their scheme's members. In those discussions we would expect fund managers to provide evidence to the trustees that investments in those types of investments are expected to benefit DC members, after fees and cost. This is a primary consideration, which would then lead on to the secondary discussion on the payment of performance fees to enhance the prospect of achieving better benefits for savers.

Proposed changes to regulations and commentary

129. This section summarises the regulatory changes we are proposing to introduce in relation to the exemption of performance-based fees through the 2023 Regulations.

130. The 2023 Regulations amend the following in relation to the exemption of performance-based fees.
    - the Occupational Pension Schemes (Charges and Governance) Regulations 2015[11] ("Charges and Governance Regulations")
    - the Occupational Pension Schemes (Scheme Administration) Regulations 1996 ("Scheme Administration Regulations")

[11] - The Occupational Pension Schemes (Charges and Governance) Regulations 2015 (legislation.gov.uk)

- the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 ("Disclosure Regulations")

Regulation 1 - commencement and application of the proposed changes

131. We propose that schemes in scope would be able to begin to apply the exemption to exclude 'specified performance-based fees' (definition covered in Regulation 2 below) from the charge cap calculations as soon as the regulations come into force (which is currently anticipated to be 6 April 2023).

132. Regulation 1(6) provides details of the transitional arrangements that apply to trustees or managers of schemes that are making use of the current option to smooth the incurrence of performance fees over a five-year moving average when assessing compliance with the charge cap. This smoothing measure was originally introduced by Regulation 7 of the Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021[12]. The smoothing option can only be applied up to the date which is 5 years after the end of the first charges year in which the trustees or managers first chose to calculate the charge imposed annually.

Regulation 2 – amending the Charges and Governance Regulations

133. Regulation 2 of the 2023 Regulations proposes to repeal the previous description of 'performance fee' contained in Regulation 2(1) of the Charges and Governance Regulations and replace this instead with a tight conditions-based definition of what can be considered a well-designed, "specified performance-based fee" structure that trustees or managers of DC and CMP schemes that are covered by the charge cap must follow if they want to exclude these performance-based fees from their charge cap calculations.

134. The amendment would see performance-based fees join a list of 'charges' that can be considered out of scope of the charge cap that includes transaction costs, costs of winding up the pension scheme and costs solely attributed to holding physical assets, such as land or buildings. The exemption would not apply to components of a performance fee structure that are not linked directly to investment performance, such as any fixed rate management fee or other costs. These would continue to remain subject to the charge cap.

135. This proposed change aims to incentivise trustees and managers to link payment of fees directly to the net benefit that their scheme members receive. The change hopes to provide flexibility for trustees to accommodate performance fee charging models whilst still retaining the protection of the charge cap in relation to any management fees which are not linked directly to performance outcomes. It is hoped that the change will facilitate the development of fee structures, with lower

[12] The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (legislation.gov.uk)

base management fees, which may be more appropriate for use in relation to DC schemes, if there is sufficient investor demand.

136. Our proposed new definition of ‘specified performance-based fee’ will relate to a fee paid when returns from investment exceed a specific rate/benchmark (commonly a hurdle rate) or a specific amount (typically applied using a high-water mark or other mechanism), which may be variable or fixed, but crucially must be agreed upon between the trustees or managers of the scheme and the fund manager prior to investing.

137. We have been careful not to prescribe the use of particular fee structures or the level or amount that should be set out. This is for the trustees or managers of the scheme, with support from their advisors and the fund manager to agree based on the nature of the investment proposed. When investing without the full security of the charge cap, trustees and managers should seek advice on, for example, what is an appropriate hurdle rate for the investment proposed and should also consider the application of mechanisms such as a high-water mark or a fee cap to ensure fund managers are not taking excessive risk or being paid repeatedly for the same level of performance.

138. The proposed definition does not preclude performance-based fees from applying to any asset class invested in. We believe precluding asset classes would present practical challenges in defining how assets held within portfolios should be allowed for as part of the performance-based fee assessment over different periods and also create the risk of regulatory arbitrage.

139. The feedback we received from our discussions with stakeholders and from previous consultations was that in being too prescriptive around fee structures, we would limit the ability of trustees and fund managers to develop appropriate investment propositions. In a changing and evolving market, that has many variables, we want to give trustees the flexibility to be able to negotiate the best terms in the best interests of members.

140. The proposed definition of specified performance-based fees also sets out that trustees or managers of the scheme must have agreed, with the fund manager the time period over which any performance-based fee will be measured and paid prior to the trustees or managers investing in the investment product. The time period is usually annually, however, could be more frequent for more established assets and funds with a shorter lifespan.

141. To provide a form of member protection, the definition also includes a provision that trustees or managers of schemes must agree with the fund manager methods to mitigate the risk that the amount of the fee is increased as a result of short-term fluctuations in performance or valuations of the investment. This is in response to concerns raised at consultation that in some periods scheme members could receive outperformance but then not be reimbursed in the instance of poor performance.

142. Regulation 2 also sets out that trustees or managers of the scheme must have regard to any statutory guidance produced that accompanies these regulations.

143. As a result of the changes to how performance fees are treated, we propose to repeal provisions introduced through the Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021[13] that allow schemes to smooth (save for transitional arrangements set out above) or pro-rate the effects of performance fees for the purposes of the charge cap.

Regulation 4 – Amending the Scheme Administration Regulations

144. Regulation 4 (3) and 4(4) proposes to amend Regulations 23 and 25 of the Scheme Administration Regulations respectively, to require trustees or managers of DC and CMP schemes in scope to calculate and disclose in the annual chair's statement any performance-based fee charges members incur as they would all other costs and charges.

145. We propose that fees are calculated and reported for each default arrangement (if any) during the scheme year, as a percentage of the average value of the assets held by that default arrangement during the scheme year.

146. Trustees or managers would also need to extend the assessment already required of where costs and charges provide value for members to also cover performance-based fees.

147. Stakeholders to our previous consultation agreed unanimously the importance of transparent communications to members on performance-based fees which would not be subject to the charge cap.

Regulation 5 – Amending the Disclosure Regulations

148. Regulation 5 proposes to amend regulation 29A of the Disclosure Regulations to require trustees or managers of DC and CMP schemes to publish the section of the chair's statement which covers payment of performance fees on a free to access website.

149. Publication of charges and cost information is important to members and can also enable trustees and others to compare the value for money they are receiving through their scheme's arrangements with their peers, thereby driving better market outcomes. By giving wider industry participants and commentators access to the data, this could also assist in the development of benchmarking services.

Question 6: Do you have any comments on the draft regulations in relation to the performance fee measures? Please include in your answer any comments on whether you consider they meet the stated policy intent.

Question 7: Are there other elements not covered in these regulations that you would expect to see?

[13] The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (legislation.gov.uk)

Draft Statutory Guidance

150. The draft statutory guidance seeks to ensure that trustees have a fuller understanding of what conditions/elements make up a specified performance-based fee which they must follow if they want to be able to exclude these fees from their charge cap calculations. The draft statutory guidance also explains the disclosure requirements.

151. Stakeholder feedback was that there is already a significant amount of regulatory and supervisory material relating to performance fee structures in existence, including FCA principle-based guidelines on the use of performance fees[14], covering the choice and application of benchmarks or hurdles, and guidance on accrual periods and disclosures. We do not wish to replicate what is already established market practice in this guidance.

152. The draft guidance also includes information on measurement and payment periods to help explain the timing of performance fee deductions from members' pots, taking account of fair apportionment to scheme joiners and leavers, as well as helpful suggestions to how this barrier could be alleviated.

Question 8a: Do you have any comments on the performance fee sections of the draft statutory guidance? **Question 8b: Are there any areas where further clarity might be required?**

Costs and Benefits

153. As these the proposed regulations and associated statutory guidance do not impose any requirements on trustees of occupational pension schemes to enter into any investment arrangement that includes paying performance-based fees we did not consider a full impact assessment was necessary.

154. Many of the comments we received in response to our November 2021 consultation did not anticipate introducing this change would bring about any significant direct costs to businesses. The costs associated with this policy are expected to be predominantly the costs of disclosing any performance-based fees which are excluded from the scope of the charge cap. There is also an expected one-off familiarisation cost on providers to read and understand the regulations.

[14] COLL 6.7 Payments - FCA Handbook

155. The benefits of removing performance-based fees from the charge cap acts as a prompt for schemes to invest and diversify investment portfolios to reach higher portfolio values over time. This policy will allow schemes to invest in illiquid assets through funds with performance related fees without the fear of breaching the charge cap from higher performance fee charges as a result of higher levels of return being delivered.

Question 9: Do you have any comments on the impact of our proposals, in relation to the exemption of performance-based fees on protected groups and how any negative effects may be mitigated?

Annex 1: List of respondents to Chapter 2 of ‘Facilitating investment in illiquid assets’

The Association of British Insurers (ABI)
Association of Consulting Actuaries Limited (ACA)
Aegon
Association of Investment Companies (AIC)
Aon
Association of Pension Lawyers (APL)
Association of Real Estate Funds (AREF)
Aviva
UK BioIndustry Association (BIA)
CFA Society of the UK (CFA UK)
The Coalition for a Digital Economy (Coadec)
Connected Asset Management
Cushon
Eversheds Sutherland
Hargreaves Lansdown
HSBC
Hymans Robertson LLP
The Investment Association (IA)
Institute and Faculty of Actuaries
The Investment Property Forum (IPF)
Isio Group
John Forbes Consulting LLP
Legal & General (L&G)
Lane Clark & Peacock LLP (LCP)
M&G plc
Mercer
Natixis Investment Management
Nest
Partners Group
Pensions Management Institute
Phoenix Group
Pinsent Masons LLP
The Pensions and Lifetime Savings Association (PLSA)
Scottish Widows
Smart Pension
The Society of Pension Professionals (SPP)
State Street Global Advisors
techUK
Tesco
The Investing and Saving Alliance (TISA)
The Universities Superannuation Scheme (USS)
XPS Pensions Group

Annex 2: Consultation questions

Question 1: Do you have any comments on the draft regulations in relation to the disclose and explain provisions? Please include in your answer any comments on whether you consider they meet the stated policy intent.

Question 2: Are there other elements not covered in these regulations that you would expect to see?

Question 3a: Do you have any comments on the proposed regulatory asset allocation disclosure requirements included in the draft statutory guidance?

Question 3b: Are there any areas where further clarity might be required?

Question 4: Do you agree with the information presented in the impact assessment?

Question 5: Do you have any comments on the impact of our 'disclose and explain' proposals on protected groups and how any negative effects may be mitigated?

Question 6: Do you have any comments on the draft regulations in relation to the performance fee measures? Please include in your answer any comments on whether you consider they meet the stated policy intent.

Question 7: Are there other elements not covered in these regulations that you would expect to see?

Question 8a: Do you have any comments on the performance fee sections of the draft statutory guidance?

Question 8b: Are there any areas where further clarity might be required?

Question 9: Do you have any comments on the impact of our proposals, in relation to the exemption of performance-based fees on protected groups and how any negative effects may be mitigated?