ASSOCIATION OF CONSULTING ACTUARIES

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Issued by email
pensions.investment@dwp.gov.uk

To Whom it May Concern

Incorporating Performance Fees Within the Charge Cap

I am writing on behalf of the Association of Consulting Actuaries in response to the above-named consultation issued by the DWP.

We trust that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 07557 031198 or at tessa.page@mercer.com.

Yours sincerely

Tess Page
Chair, Defined Contribution Committee
On behalf of the Association of Consulting Actuaries Limited

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Incorporating Performance Fees Within the Charge Cap

Q1: Question 1: Are the performance fee regulations:

a) clear

b) likely to be taken up by trustees

c) going to make a difference to trustees' confidence to invest in illiquids?

The proposed regulations allow trustees to "swap out" the existing calculation bases for a 5-year moving average of accrued performance fees. In principle, this is likely to reduce the risk of a charge cap breach.

The worked examples provided in the consultation are helpful, but overall we believe the new method (which can be used **only** for performance fees, under the proposals) is unlikely to be seen as "clear" by trustees. In particular, the calculations introduce administrative complexities that will be challenging given the way in which many DC funds are operated in practice, namely:

- A number of underlying funds (some of which could have performance fees and some of which may not) are often wrapped within a single vehicle.
- Funds are often held on investment platforms and the "provider" rather than the trustees prepares cost disclosures.
- The operational requirements will largely be for investment managers to implement, who will have to provide regular information on the level of performance fees being applied within the fund.
- It will therefore be critical for all parts of the chain to be able to supply the information in the required form.

ACA members provide advice to thousands of employers and pension schemes with assets exceeding £1 trillion, including most of the country's largest schemes. Our experience is that performance fee calculations are not the primary driver of any trustee reluctance to invest in illiquid assets. The barriers are set out in our response to question 5.

Q2: What is the likely appetite that pension scheme trustees have for investment in venture capital and/or growth equity?

Trustees have appetite for investments capable of offering attractive risk-adjusted long term returns net of costs and charges, through investment vehicles that are straightforward to implement and monitor. Trustees are open minded to new ideas.

Within our trustee client base to date, we have not seen any significant appetite for investing specifically in venture capital and/or growth equity. However, we do see appetite for diversified private market, less liquid investments, particularly from larger schemes.

Q3: How do you currently treat look-through when calculating the charges regime of the scheme?

We believe that investment managers and platform providers will be better placed to respond to this question.

Q4: Does look-through act as a significant barrier to investment into investment vehicles that allocate to VC/GE?

Our view is that the look-through requirements are not a current significant barrier to the current lack of appetite (see question 5 below).

Q5: Are there more significant barriers to the success of pooled illiquid investment vehicles than look-through? If so, what are they?

The barriers to investing in less liquid assets for DC scheme trustees have, to date, not been the implementation or monitoring of performance fee structures. Rather, the lack of confidence stems from:

- Practicalities around managing the illiquidity, and the extent of work required with the administrator, platform provider (if relevant) and other parties to implement a fund. An example of the challenges wrought by less liquid funds was provided during 2020, when many pooled, daily priced property funds suspended trading owing to difficulties in valuing the underlying assets. This delayed retirement for some DC savers and resulted in governance burdens for trustee boards in identifying suitable “default” arrangements for the redirection of contributions.
- Understanding what would happen in the event of fund gating (the practice of temporarily blocking withdrawals from a fund), particularly for members close to retirement or for any members seeking to transfer their fund to another arrangement.
- Availability of suitable vehicles in which to invest (particularly for schemes on platforms), which have a total cost (whether performance related or not) that trustees assess to be good value for the benefits provided.
- Difficulties of blending such a strategy with other, more liquid, funds in blended funds.
- Mixed evidence in relation to the risk-adjusted returns available from such investments.
- Practical challenges in how cashflows are managed during the various stages of private market investments (formation, investment, harvesting, and extension phases).
- Variable knowledge levels on trustee boards, combined with a governance budget (in terms of both time and financial resources) that is already stretched thinly.

Consolidation and pooling of assets would be expected to help support increased investment in illiquid investments. However, we have observed that a significant proportion of schemes looking to consolidate through a master trust arrangement focus on “measurable” costs and charges, rather than overall value and long term member outcomes. This in itself presents a disincentive for commercial master trusts to implement such strategies, as implementing even a small allocation to such investments can increase the costs for these master trusts. We also note that, whilst larger own trust schemes may have the scale to obtain investments with fees that are seen as appropriate, smaller schemes are unlikely to be able to do so.

Q6: If perceived as a significant barrier, how can the government act to ensure it is removed whilst maintaining member protection/the objectives of the charge cap? Should this change be a regulatory one or in guidance?

We do not believe that this is a significant barrier currently.

Q7: Is there a risk of arbitrage? How can this be mitigated?

We agree that consideration must be given to inadvertently favouring one type of investment or structure of investments to another. Our preference would be to avoid subsidising particular asset classes (either directly or through “preferred” treatment in how costs and charges are calculated) in order to reduce this risk. Preferential treatment not only increases arbitrage risk, but may contribute to trustee and industry “suspicion” in relation to illiquid investments.

Q8: Are there recognised industry definitions of venture capital and growth equity?

The definitions put forward by the British Private Equity and Venture Capital Association are generally well-used, albeit not in a formalised “industry standard” manner.

Q9: Are there any other proposals that the government should consider to allow greater investment in venture capital or growth equity?

Both venture capital and growth equity are high risk investments, and are complex in nature. Whilst the potential upsides can be attractive, there is a risk of significant downside. We would therefore support any initiatives or guidance which support trustees in how they review, implement, monitor and communicate such investments. In respect of communications in particular, the relatively complex nature of these investments means that communications in relation to the risks involved may be challenging and (if not done well) could lead to members claiming that they had been misled as to the aims of the investment.

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