THE SOCIETY OF PENSION PROFESSIONALS
*making pensions work*

To be submitted via template form

10 November 2022

**SPP response to DWP consultation on Broadening the investment opportunities of Defined Contribution schemes.**

## 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.

In light of the pension liquidity crises, one has to challenge oneself of the appropriateness of material illiquid asset allocations in any pension scheme, but it seems reasonable to conclude that a place remains for them, if risks are carefully managed. We note however that the disclosures might have the oppositive impact from that intended – given the adverse press coverage about pension scheme liquidity, disclosures surrounding illiquid allocations could potentially get a negative reaction from members, discouraging the use of the broader opportunity set.

Another point that financial market crises teaches us is that liquid assets can be hard to trade in times of market stress. Therefore, we would suggest that the definition of illiquids should reference 'normal functioning markets'. For example, sterling credit was difficult to trade in the recent gilt crisis and the provisions should avoid assets flopping in and out of an illiquid definition as market conditions change.

We believe it is unrealistic to exclude certain costs e.g. legal and training costs from the cost benefit analysis. While legal advice may not be required under regulations for these disclosures, trustees and their consultants will not wish to fail to meet all of the requirements of new regulation so legal advice will be widely sought.

The Society of Pension Professionals
124 City Road, London, EC1V 2NX T: 020 7353 1688
E: info@the-spp.co.uk www.the-spp.co.uk

We also have the following technical comments on the draft Regulations:

- **Specified performance fees, inclusion in VFM assessments** – Regulation 25(1)(b) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 is amended to specifically refer to specified performance-based fees so that trustees have to assess whether they represent good value for members. Given this amendment, we consider Regulation 25(1A), should also be amended to include reference to specified performance-based fees after the word 'charges'.
- **Scope and impact on small schemes**: According to the Consultation Document (paragraph 93) and the Impact Assessment Document (page 3), the scope of the amendments of the SIP and Chair´s statement is consistent with current rules, that is, applicable to schemes with 100 or more members. However, the draft regulations amend Regulation 2A (Additional requirements in relation to default arrangement). While schemes with less than 100 members don't have to produce a SIP under Regulation 2, this exemption (contained in Regulation 6) does not extend to Regulation 2A. Therefore, we do not think the impact assessment for small schemes is correct as the amendments to Regulation 2A will apply to them and so they will be impacted by the proposals. The amendments included in Regulation 4(5) of the draft Regulations will also apply to them.
- **Renumbering needed** - There is already a Regulation 2A(7) in the Occupational Pension Schemes (Investment) Regulations 2005. The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2023 should renumber existing Regulation 2A(7) to 2A(8).

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

We believe that asset allocation averaging should not be the recommended approach to the annual disclosure. Trustee boards will likely feel under pressure not to deviate from the recommended approach and as was made clear by earlier consultation responses, this will usually be disproportionate.

The draft statutory guidance has the potential to create as many issues as it attempts to solve. While we appreciate that on the face of it defining broad asset class groupings might aid consistency in reporting and comparability across schemes, the guidance is too simplistic and there are asset class opportunities that do not obviously fit within any of the definitions and asset class opportunities that might fit across more than one bucket.

Some examples are:

- Certain properties with a social benefit (e.g. social housing, student accommodation, care homes and hospitals) might also be infrastructure assets
- Infrastructure debt has very different characteristics to infrastructure equity – the former would often be seen as part of a private credit allocation and the latter might be considered private equity
- Rather than private credit the guidance refers to private lending to companies, but many private credit opportunities aren't direct lending to companies; e.g. commercial real estate loans, fund financing
- It is not clear where overseas government debt is supposed to be disclosed

- A REIT is a listed equity, so on the face of it perhaps it should be included in public equity allocation (it could feature in a passive equity market tracker for example), but a dedicated REIT portfolio, in the spirit of looking through a fund structure to underlying, raises the question of whether it should be put in the same bucket as an open-ended pooled property vehicle? Property exposure can also be gained through an equity holding in a property company listed on an exchange.

While it might take away from comparability, we would support the approach to disclosing asset allocation being left to schemes rather than being prescriptive, with some examples that illustrate some potential alternatives that are acceptable. We note that the need to invest in assets in a way that fits with a prescribed bucket might stifle innovation.

Additionally, although the aim of the draft regulations is to increase the level of transparency for members, in our view it is debatable what level of engagement members would have with the asset allocation disclosure and, indeed, whether they would properly understand them. Getting members to engage with their own benefit statements is challenging enough, and so we question how many members would actually read these disclosures.

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

See above.

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

In general terms, we agree. However, regarding the costs, we would like to note that, although it is correct to say that policy-related costs are to be predominantly those of disclosing any performance-based fees, it is also true that doing this could imply in some cases relevant costs for managers and pension providers as they would need to look through the funds and decide whether if disclosure applies. On that note, we would like to note that the impact assessment should give further consideration to these costs (partially addressed in paragraph 43, page 7, Impact Assessment Document), even if they are not inherently high.

**Question 6: Do you have 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?**

The proposal to exempt performance-based/performance-related fees from the regulatory charge cap is likely to help broaden the range of available investment opportunities, and so at a high level (and subject to the comments below), the drafted regulations can meet the stated policy intent.

The key issue (which is acknowledged by the paper in paragraph 116) is the performance-related fee needs to be ***well-designed*** so that fees are paid only when ***genuine performance has been achieved***.

There are a range of different parameters which can feed into a typical performance-related fee arrangement, and it is incumbent on the Trustees to carefully consider these parameters to satisfy themselves that fees are being paid for true manager-influenced performance ("***manager alpha***") and not simply for market-related performance ("***market beta***"). The drafting of the regulation should seek to ensure that only performance fees on manager alpha fall outside the fee cap. However, the choice of these parameters can result in a complex discussion, particularly for unusual or novel asset classes (which may have no readily available benchmark) and so it is incumbent on Trustees to seek advice from an independent third party or include Trustees who have sufficient expertise on their boards.

The design of performance-related fees for illiquid assets increases this complexity further. Such assets are less likely to have a readily available market price which then necessitates valuations by a third party in order to determine the performance-related fee. An understanding of these third-party valuers and the methodology used for such valuations is important. Are there potential conflicts of interest between the valuer and the asset manager? Will any price smoothing be applied and what is the nature of this mechanism? A requirement to incorporate additional scrutiny to valuations should be considered before permitting performance fees outside the charge cap, e.g. third party valuer rotation after a set period of years or a range of valuations to reduce the impact of subjectivity. Paragraph 141 references a provision that Trustees 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* " which implies such smoothing may occur and so highlights the need for Trustees to fully understand the valuation methodologies being employed.

Another related complication specific to performance-related fees for illiquid assets is minimising the timing lags which may result in a difference between the unit-holders who benefited from the performance of these assets with those who will be paying for the performance. These two groups are not expected to exactly coincide for various reasons such as common lifestyle switching or a unit-holder leaving the scheme. Therefore, it is important that Trustees are comfortable with this and have fully considered the implications. Similarly, paragraph 134 states that performance-based fees joining a list of charges that will be considered to be out of the scope of the charge cap. Due to potential timing differences, one will need to consider whether estimated or actual performance-related fees will be included for this purpose.

Paragraph 138 states the definition "*does not preclude performance-based fees from applying to any asset class invested in*" for reasons of practicality. However, this does open the possibility of moving more of the investment management fees to be on a performance-related basis for competitive reasons so as to minimise the fees subject to the charge cap and so optically look favourable relative to other providers.

Paragraph 117 proposes that any performance-based fee would need to be disclosed and assessed as offering "*value to members*". This is necessarily a subjective assessment and may require some independent assessment of reasonableness.

On the drafting of the Regulations - Regulation 25(1)(b) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 is amended to specifically refer to specified performance-based fees so that trustees have to assess whether they represent good value for members. Given this amendment, we consider Regulation 25(1A) should also be amended to include reference to specified performance-based fees after the word 'charges'.

**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?**

Certain protected groups might have periods of short service. The potential for misalignment between who receives the benefits of performance and who pays for it might therefore be particularly acute.