Sackers

Incorporating performance fees within the DC charge cap

Alert | 22 March 2021

Introduction

Further to an announcement in this year's Budget (see our Alert), on 19 March 2021, the DWP issued a consultation on proposed measures to allow occupational DC schemes to smooth performance fees within the charge cap, and a call for evidence on "look-through" in relation to charge cap compliance ("the Consultation").

Key points

- Following a consultation in September 2020 ("the 2020 Consultation") (see our Alert), the Government is consulting on draft regulations which are intended to enable the diversification of DC investment portfolios.
- As part of its "commitment to removing perceived barriers to the commercial viability of innovative fund vehicles", the Government is also seeking views on the current position on look-through in relation to charge cap compliance, as a potential barrier to investment in alternative asset classes, particularly venture capital and growth equity.

Background

The Government believes that investment in "emerging sectors like green infrastructure or innovative British companies fits well with the long-term horizons of DC schemes", and is "vital to helping sustain employment, our communities and the environment". In addition, while pension schemes have traditionally tended to dedicate the majority of their investment portfolio to public markets, the expansion of DC provision following auto-enrolment has resulted in some DC trustees "looking to access a more diverse portfolio of assets, including illiquid assets that have the potential of even greater return".

Although it is possible to make such allocations without paying performance fees, a performance-related element is common. Moreover, performance fees can incentivise the investment manager to achieve higher returns for their client, as this will trigger a more profitable pay-out for themselves.

Charge cap compliance: proposed changes

Currently, there are two different methods for calculating the charges that can be imposed on members in a DC default fund in any given year. Both require the level of charges for that year to be based on the costs and charges the scheme has paid during that period. The proposed regulations would allow an exception to this requirement in respect of performance fees.

Instead of being required to look back on (in the case of the retrospective method), or predict (in the case of the prospective method), the performance fees incurred over the course of the charges year, trustees would be able to "swap out" this figure for a 5-year moving average of accrued performance fees. The majority of the responses to the 2020 Consultation agreed that such a change would reduce the risk of a charge cap breach and could also increase investment in illiquid assets.

For this purpose, a "performance fee" will mean a fee which:

- is calculated by reference to the returns from investments held by the scheme, whether in terms of the capital appreciation of those investments, the income produced by those investments or otherwise, and
- is not calculated by reference to the value of the member's rights under the scheme.

A series of illustrative examples has been developed in order to provide guidance on how a multiple year smoothing approach would work in practice.

Look-through

The current position is that trustees of occupational DC pension schemes should "look-through" any fund of funds or pooled investment vehicles, no matter the type of funds such vehicles invest in. This means that trustees should not just incorporate the costs of investing in the pooled vehicle, but should "look-through" this structure and consider the costs paid by the pooled vehicle manager as it invests in other funds, known as the underlying investments.

In the 2020 Consultation, the Government made clear that look-through should apply when investing in all open-ended funds, all UK listed closed-ended investment funds, as well as international equivalents. Since then, it has been suggested that:

- this policy makes it less attractive for trustees to invest in certain types of closed-ended investment funds, namely, venture capital investment trusts and other vehicles that make allocations to illiquid assets
- the requirement for trustees to look-through to underlying investment costs may be stifling product innovation that would otherwise expand the range of products offered by DC schemes.

Aiming to improve investment diversification and innovation, views are sought on the treatment of look-through and whether this is incompatible with the nature of illiquid investments. The Government is also seeking input on trustees' likely appetite for such investments and whether they perceive look-through to be a barrier.

Next steps

The consultation closes on 16 April 2021.

The Government aims to publish a response to the Consultation (including final draft regulations and final statutory guidance) in June 2021, alongside a response to the remainder of the 2020 consultation. As things stand, the regulations on performance fees are intended to come into force in October 2021.

If you have any questions on any of the above, **please speak to your usual Sackers contact**.

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