BlackRock.

16th April 2021

Sam Haylen, Vicky Bird, Tessa Lubrun, Andrew Blair
Department for Work and Pensions
Caxton House
Tothill Street
Westminster
London
SW1H 9NA

Submitted via email to: pensions.investment@dwp.gov.uk

RE: Incorporating performance fees within the charge cap

Dear Sam, Vicky, Tessa, and Andrew,

BlackRock[1] is pleased to have the opportunity to respond to the consultation on incorporating performance fees within the charge cap, issued by the Department for Work and Pensions.

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of the DWP on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

Auto-enrolment and the growth of workplace pension scheme membership is a success story for the UK. Ever more people are now saving for their retirement through these schemes and opt-out rates are incredibly low. The use of the charges cap has been an important part of building trust and consent for what was a significant shift in the UK's retirement and pensions policy.

At the same time, the growth in size and sophistication of these schemes, as well as the pressing need to ensure their investments can provide end-investors with retirement security, means the overall approach to regulation of workplace schemes should be kept under review. Policymakers have rightly identified the tension between the application of the charges cap, and schemes' ability to make allocations to asset classes and investment strategies that have higher fees, or charge performance fees.

This is particularly important for long-term, illiquid asset classes. Investment strategies in these areas tend to have higher fees, and frequently make use of performance fees to align incentives between managers and end-investors. This is true not just for venture capital and growth equity (VC/GE), which is emphasised in this consultation, but also for private debt, infrastructure, real estate, and a range of other investment types within this area. We therefore strongly recommend that any policy changes tackle the issues in the broadest way possible, and does not attempt to target interventions solely at VC/GE.

The fundamental issue for using performance fees under the charges cap is the uncertainty about investment performance, which means the final performance fee cannot be known in advance. While the proposed smoothing mechanism could well reduce the likelihood of a breach, it does not rule out the possibility completely, and would add significant complexity to the calculation. We therefore do not think it will materially increase uptake of performance fee-paying strategies; and instead recommend placing a limit on the proportion of a workplace pension schemes' portfolio that can be invested in strategies that use performance fees – for example at 35% – while excluding performance fees from the charge cap calculation.

The consultation also raises the issue of 'look-through' to the charges for underlying sub-funds and fund-of-funds. We agree that a requirement to consider those fees in the charges cap calculation would be a significant barrier for allocations to long-term and illiquid assets in general. Conceptually, these fees should be thought of as a cost of running the investment – akin to taxes, brokerage fees, or transaction costs. We therefore support the proposal to remove performance fees, management fees, and the costs of underlying investments from the overarching look-through requirement. However, we strongly believe that this exemption should not be narrowed in any way to 'VC/GE', and should be applied across the board. The regulatory arbitrage risk DWP rightly raises in this context is better managed through transparency and disclosures about the fees charged by any underlying funds, which trustees can in turn assess as part of their investment due diligence and monitoring.

Finally, we emphasise the importance of two other factors that will be crucial to increase investment in illiquids: firstly, shifting the wider ecosystem – including distribution systems and platforms – to support varying dealing frequencies; and secondly fostering a cultural shift for workplace pension schemes, moving away from a cost-reduction mindset, and towards a focus on outcomes, judged by net-of-fees performance and end investors' ability to generate adequate retirement savings.

Responses to questions

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 are conceptually clearer and simpler than previous proposals. While we believe the smoothing mechanism would be an improvement on the current situation and previous work-arounds, we are concerned that it would not be taken up by trustees, nor make a significant difference to their confidence for investing in illiquids.

Fundamentally, the barrier to using performance fees within the charges cap is that uncertainty around investment performance translates into uncertainty about the upper limit of performance fees that might be incurred: the final amount cannot be known in advance.

While the proposed smoothing mechanism could well reduce the likelihood of a breach, it does not rule out the possibility completely – particularly in private markets where returns can often be 'lumpy' and notably larger than in public markets. In turn, it is not clear what trustees would be required to do in the event of a breach, how they would mitigate its impact on their compliance with the charges cap, or how a breach would be viewed from a regulatory perspective. Another issue is the significant complexity the mechanism would add to calculating fees and compliance with the cap.

Performance fees are a useful means of aligning incentives between asset managers and end-investors, given that increased fees are only paid to the manager where they deliver outperformance to the client above a hurdle net of fund costs. When DWP have raised similar questions in the past, we have advocated for a more flexible application of the cap, which would allow sophisticated schemes that fulfil certain eligibility criteria, to enter into arrangements with uncapped performance fees, and exclude performance fees for the purposes of the charges cap calculation. We further suggested that this should only be permitted with strong investor protection controls, and accompanying guidance on permissible types of performance fees structures.[2] We continue to believe that this would be an appropriate policy option, given the alignment with end-investor interests. Indeed, accessing a wide range of strategies and the best managers will be critical to designing an effective private markets program for schemes. If the DC market has unique fee restrictions on their private market requirements, it risks struggling to compete for investment opportunities compared to other institutional investors.

At the same time, we recognise that the original intention of the charge cap was to limit the overall fees that can be incurred by end-investors, and that this has been an important part of building trust and consent for what was a significant shift in the UK's retirement and pensions policy. But for the reasons outlined above, the charge cap – even with modifications – is not compatible with the use of performance fees. And without entirely removing the risk of outperformance leading to a breach, it is unlikely that take-up of the types of investment strategy that use them will increase.

We therefore recommend an alternative option that may help to balance these two objectives: placing a limit on the proportion of a workplace pension schemes' portfolio

[2] BlackRock (April 2019), Response to 'Investment Innovation and Future Consolidation'

that can be invested in strategies that use performance fees – for example at 35%, which is in our experience around the top end of clients' target allocations – while excluding performance fees from the charge cap calculation. We believe this would help fulfil the competing objectives of allowing more use of performance fees, and in turn more workplace scheme investment in private and illiquid markets; while also restraining the absolute level of fees borne by the end-investors.

Question 2: What is the likely appetite that pension scheme trustees have for investment in venture capital and/or growth equity?

Alternative and less liquid investments are an important part of diversified portfolios, given their low correlation to equities and bonds – reducing risk, and improving returns. Less liquid long-term investments such as infrastructure are also especially suited to the long-term profile of Defined Contribution pension funds and provide protection against the risk of rising inflation. Similarly, exposure to other private markets such as private equity, venture capital, and growth equity offer significant growth potential as well as diversification benefits.

However private debt, infrastructure, and real estate are additional alternative asset classes that can contribute regular income streams and diversification benefits to a portfolio. Taken broadly, these alternative or less liquid asset classes could account for anything up to 35% of a portfolio – which is around the top end of our clients' appetite for allocations in these assets.

Question 3: How do you currently treat look-through when calculating the charges regime of the scheme?

No comment: BlackRock does not do this as an investment provider.

Question 4: Does look-through act as a significant barrier to investment into investment vehicles that allocate to VC/GE?

We agree that any requirement to look-through to the costs or charges of underlying investments, and consider those costs in the charges cap calculation, would be a significant barrier to vehicles allocating to VC/GE, and to long-term and illiquid assets more generally. It is possible that charges for any underlying investments may individually be higher than the charges cap, while the overall investment solution fee is within the charges cap. If the charges for any underlying investment vehicle must also be 'tested' for compliance with the charges cap, this would likely rule out a range of products, particularly within the alternative and illiquid investment space. However, we believe that for the purpose of the charges cap, compliance should be based on the actual fee incurred by the end-investor, and the main focus for trustees should be on realised net-of-fees performance. We elaborate on this under questions 6-9.

Question 5: Are there more significant barriers to the success of pooled illiquid investment vehicles than look-through? If so, what are they?

One of the biggest barriers to wider take-up of pooled illiquid investment vehicles is the structure of the wider ecosystem for distribution and administration, where operational models are mainly based around more liquid investments and daily dealing fund structures. Investment platforms generally require daily liquidity from funds, in order to make them compatible with their operational systems. Moving towards a more flexible model that can accommodate varying dealing frequencies would be beneficial

– indeed this is an issue being considered by the Productive Finance Working Group led by HM Treasury, the Bank of England, and the Financial Conduct Authority.

Another important barrier is a tendency within the workplace pensions space to focus on costs, and cost reduction, rather than end-investor outcomes and net-of-fees performance as a measure of success. While the charges cap has been an important means of preventing excessive fees for end-investors and thereby securing consent for auto-enrolment, it has also fostered a reluctance to increase costs, even within the cap, of investment strategies. This limits the range of investment strategies it is possible to include in defaults, with competition among investment propositions tending to be based heavily on price, rather than on outcomes; and means the most common approach to investments are using lower-cost index investment products as building blocks for portfolios. To the extent that illiquid investment vehicles tend to have higher management fees and performance fees, this is a significant barrier to investment in them, which is ultimately to the detriment of end-investors in being able to diversity their portfolio and generate returns.

Question 6: 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?

Question 7: Is there a risk of arbitrage? How can this be mitigated?

Question 8: Are there recognised industry definitions of venture capital and growth equity?

Question 9: Are there any other proposals that the Government should consider to allow greater investment in venture capital or growth equity?

Questions 6-9 are answered together here.

For the purposes of the charges cap, we believe that look-through should not apply for any product or asset class. The most important factor for end-investors is net-of-fees performance, with overall performance and the headline fee paid being the two factors that contribute to this. While the product in question may be a fund-of-fund solution, or contain underlying funds, the fees charged by these structures should be considered a cost incurred in managing the investment or building an overall investment solution – in the same way as broker fees, transaction costs, or taxes are – rather than a ‘fee’ charged to the investor.

That said, we believe the concern about regulatory arbitrage raised by the DWP is a legitimate one, and it is crucial that these types of structures are not used to facilitate ‘hidden’ or excessive fees. This risk is best managed through transparency and disclosures about the fees charged by any underlying funds, which trustees can in turn assess as part of their investment due diligence and monitoring. Placing a de-facto cap on charges for underlying funds will have the impact of narrowing the asset classes and investment solutions that can be included in default investment options, in turn hampering the retirement outcomes of end-savers.

We therefore support the suggestion of a “regulatory solution which would remove performance fees, management fees, and the costs of underlying investments from the overarching look-through requirement” made in the consultation. However, we strongly believe that this exemption should not be narrowed in any way to ‘VC/GE’. This is partly for practical reasons – as DWP notes, it may be difficult to clearly define

'VC/GE', and offering an exemption for just one type of asset class increases the risk of regulatory arbitrage. But an equally and perhaps more important reason is that targeting reforms considered in this consultation solely at VC/GE would hamper investment in infrastructure, real estate, private debt, and all other types of long-term, illiquid investment. As asset classes these are important both from an economic perspective and as an investment opportunity, and should not be subject to a different regulatory regime.

Indeed our proposals outlined above and in questions 1 and 5 would help drive more workplace pension scheme investment in long-term, illiquid investments more generally, and we would encourage Government to ensure that policy changes aim at doing this in the round, rather than focusing specifically on sub-sectors like VC/GE.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the consultation paper and will continue to work with the DWP on any specific issues which may assist in further developing policy in this area.

Related documents

Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution schemes – BlackRock response, April 2019

Review of the Default Fund Charge Cap and Standardised Cost Disclosure – BlackRock response, August 2020