

Summary

- Although now well-established in the DC auto-enrolment system, the 0.75 per cent investment charge cap is in need of some fine-tuning to help schemes realise their full investment potential.
- The government is consulting for the second time in 12 months on the details of the cap in order to make it easier for schemes to invest in illiquid assets, in particular those that support the green transition.
- It has proposed the smoothing of performance fees over several years and is also seeking views on its position around look-through in relation to charge cap compliance.
- Despite wide support for the consultation, there are concerns that some schemes, particularly larger master trusts, would not take up the increased flexibility if offered, due to competitive restraints to keep charges low.

A little fine-tuning

There's never been a better time for DC pension schemes to consider innovating their investment strategy, so says the Minister for Pensions and Financial Inclusion, Guy Opperman. That may be true, but many auto-enrolment DC schemes feel limited in what they can invest in because of the 0.75 per cent charge cap.

As a result, the government has launched yet another consultation on the fine print of the charge cap with the aim of enabling DC schemes to invest more broadly, in particular in illiquid assets, venture capital and growth assets.

A necessary protection

The charge cap was first introduced in April 2015 to much controversy in the industry; one professional trustee at the time described it as a "blunt instrument" that could lead to "unintended consequences", which he warned were "very bland products".

Six years later and the government

Natalie Tuck examines how some fine-tuning of the DC charge cap could open up a new world of investment opportunities for DC auto-enrolment pension schemes

is concerned about a lack of innovation within DC funds – namely a lack of investment in illiquid assets such as green infrastructure.

"Investment in emerging sectors like green infrastructure or innovative British companies fits well with the long-term horizons of DC schemes, and are vital to helping sustain employment, our communities and the environment," Opperman said in his foreword to the government's consultation.

If it was reckless, the government could just kill off the cap, but it knows it is a necessary protection for DC members. Now firmly embedded within the DC auto-enrolment system, it also has much more industry support.

Now Pensions director of policy, Adrian Boulding, says the provider "fully supports the charge cap" as it "provides

valuable protection to consumers who are automatically enrolled into a pension scheme that their employer, rather than the consumer, chooses".

The government's own *Pensions Charges Survey 2020* also confirmed that the charge cap has helped to drive down costs for members and ensure they continue to receive value for money on their investments.

Despite such support, there is no denying that the cap is in need of some fine-tuning to help it play in harmony with the investment potential of DC schemes. As Opperman noted in his foreword, investment in green infrastructure of innovative British companies fits well with the long-term nature of DC investments. However, he said the UK falls "behind our global partners in our commitment to these

asset classes domestically and the economy as a whole suffers from it”.

2020 consultation

The government's current consultation, looking at performance fees and look-through, is its second consultation on the charge cap in a 12-month period. Last year, it consulted on the charge cap figure of 0.75 per cent, whether to include transaction costs in the cap and the abolishment of flat fees on auto-enrolment pension pots under £100.

Following the consultation, it decided to go ahead with the latter, and keep this minimum figure under review, with a view to increase it at some point in the future. For now the charge cap percentage will remain the same and transaction costs will not be included.

Pensions and Lifetime Savings Association (PLSA) head of DC, master trusts and lifetime saving, Alyshia Harrington-Clark, says the association welcomed the government's commitment to maintaining the cap at the current level. It believes that lowering it would reduce sophistication and dampen innovation in default investment strategies.

“Our most recent research supports previous PLSA and third-party research, which demonstrated that most schemes are operating well within the charge cap. Average PLSA member charges were previously found to be 0.46 per cent. Pension schemes value the headroom this affords them to take appropriate investment choices,” she explains.

When it comes to transaction costs, from a provider perspective, The People's Pension director of policy, Phil Brown, says they are published on its own website. For him, transparency is the “right approach” rather than including them in the current charge cap.

“We believe that transparency is the right approach because if you include transaction costs within the management charge structure, this could create the unintended consequence of a scheme being unable to shift asset allocation if doing so was in the interest of members,



or alternatively, not being able to switch assets in reaction to a prospective large scale, adverse change in their value.”

However, in the eyes of the government, and many in the industry, these changes were not enough, with more tweaks necessary for DC scheme investments to realise their full potential. So, as Boulding notes, the government has put the cap “under the microscope again”.

New possibilities

As part of the new consultation, the government is consulting on measures to allow schemes to smooth performance fees within the charge cap, alongside a call for evidence on issues relating to look-through.

In regards to performance fees, it wants to change the way compliance with the charge cap is measured to give trustees flexibility to smooth such charges over a five-year period. It proposes using a rolling average to allow schemes to exceed the 0.75 per cent cap from time to time without facing consequences. If the changes are approved of by the industry, then it expects to implement the new rules in October 2021.

However, the government clarified that it remains open to finding further ways in which it can facilitate opportunities for DC pension schemes to access private markets, balanced with

the importance of the charge cap, as a protection for scheme members.

Alongside this, the government is also seeking views on its position around look-through in relation to the charge cap, whether it acts as a significant barrier to investment in alternative asset classes, particularly venture capital and growth equity, and if so, what solutions should be considered.

“It has been raised with the government that the current position on look-through in relation to closed-ended investment structures reduces the attractiveness of such products amongst DC pension scheme trustees. I want to understand whether this a consensus view of the industry and the changes the government could consider to release investment in such products whilst maintaining the integrity of the charge cap,” Opperman wrote in his foreword.

“There is a drive and desire within government and the pensions industry for DC pension schemes to look at more sophisticated and diverse investment strategies that could enhance member outcomes – in particular, to consider illiquid assets and infrastructure,” says The Investment and Savings Alliance (Tisa) head of retirement, Renny Biggins.

Historically, DC schemes have had little to no exposure to private markets, Harrington-Clark says. Indeed, the *Pension Charges Survey* found that



two-thirds of providers have no direct investment in illiquids within their default arrangements. The other third had a small proportion, typically between 1.5-7 per cent, with the majority of these assets property-related. Harrington-Clark believes that compliance with the charge cap has, at least in part, contributed to this constraint.

"We have found the charge cap has meant advisers are less likely to recommend the use of a fund with a performance fee in a default fund, except where only a maximum, capped performance fee is eligible to be paid on the underlying fund.... The charge cap alongside the public discourse on costs and charges, and as yet no consistent way to measure and compare value for money, has encouraged trustees to focus on reducing costs rather than seeking performance."

Explaining the limitations of performance fees, Pinsent Masons legal director, Michael Jones, says: "Managers' performance fees must all be included within the cap. The structure and frequency of performance fees depend on asset class, fund type and vary by manager, but generally speaking, performance fees do not fit neatly with either the prospective or retrospective method of charge cap assessment because they are based on investment return; they vary significantly throughout the year;

and they are typically event-based, instead of being valued at regular intervals.

"As a result, trustees have been cautious to diversify into private markets due to uncertainty around calculation and frequency of performance fees, particularly for members joining or leaving the scheme during the charges year where the charge cap needs to be pro-rated and trustees need to ensure compliance for any combination of joining or leaving date."

Mixed response

Despite the consultation being largely welcomed by those in the industry, there is still doubt that what is being proposed will actually make a difference.

For example, regardless of the outcome, master trusts, particularly larger schemes, tend to have "set scheme-specific, notional charge caps" far below the 0.75 per cent charge cap due to competitive pressure, Jones explains. *The Pension Charges Survey* found that the average large master trust charges 0.4 per cent on average, which ties in with the PLSA's figure of 0.46 per cent.

Brown backs this up as he says the proposed measures "are not likely to substantially increase the flow of funds from DC master trusts into expensive asset classes where managers commonly charge performance fees".

"Moving meaningful funds into these asset classes currently would raise master trust charges above the level employers and members would find acceptable. It would be more feasible if government did more to encourage the consolidation of schemes as very large schemes are better equipped to bear the higher costs without increasing the charges to members," Brown says.

However, Standard Life Assurance head of workplace strategy and commercial, Mateo Urquijo, thinks there needs to be a shift in the emphasis on cost as it's "vital" that pension funds offer diversified portfolios that have the potential to provide the level of investment returns people are looking

for as they save for their later years.

In particular, Urquijo believes it is important that pension funds are able to invest in areas that contribute to the economy and ESG challenges as we look to 'build back better' from the pandemic.

"In this respect, there needs to be a shift in the market as the investment cost will undoubtedly be more than the cap for wider assets. There will need to be a greater desire for, and acceptance that, there are some options which will cost more, and add value that is worth paying for. Providers are only one part of this equation; trustees and advisers are also crucial if we are to avoid the focus being significantly on cost, which is only one element of a scheme's decision making."

In addition, Jones believes the consultation is "narrow" and does not address the bigger issue of how DC schemes invest. For example, he says most DC schemes invest through unit-linked funds purchased within an insurance wrapper, which are caught by the Financial Conduct Authority's (FCA) permitted links rules and restricting the types of investments that insurers can make for their customers.

"Whilst the new conditional permitted links remove some of the restrictions on the type of illiquid assets, such as removing the requirements to realise unlisted securities in the short term; and set an overall limit of 35 per cent on the proportion of the fund that may be invested in those assets (excluding permitted land and property), operationally, platforms are set up for daily dealing and regular pricing of investments, which makes investment in illiquid assets difficult," Jones says.

Therefore, he says more encouraging work is being done on a wider level with the Productive Finance Working Group (PFWG) and HM Treasury review into the structure of investment funds, which will hopefully lead to systemic, structural change.

Written by Natalie Tuck