

DC Policy, Investment and Governance Team
Department for Work and Pensions
By email: pensions.investment@dwp.gov.uk

10 November 2022

Broadening the investment opportunities of defined contribution pension schemes

We, the Association of Real Estate Funds¹ (AREF), have read with interest the consultation responses to 'Introducing Disclose and Explain Policy Proposals' and the proposed legislative changes to exempt performance-based fees from the regulatory charge cap.

We believe that DC pension schemes shouldn't focus on cost alone but should consider the overall return they would receive from an investment. Although the costs for investing in illiquid assets are higher than investing in equities, for example, the schemes should look at whether illiquid assets would provide better long-term net returns. Therefore, we welcome taking performance fees out of the charge cap and requiring DC pension schemes to disclose and explain their policies on illiquid investment and their asset allocations. However, as we have mentioned in our responses to previous consultations on how to encourage DC pension schemes to invest in illiquid assets, these changes alone will not move the dial. The main barrier to DC pension schemes investing in illiquid assets is their investment platforms not having the systems to accommodate funds with notice periods for redemptions i.e. only offer daily dealing products. There is now a general acknowledgment that funds holding illiquid assets should align their redemption periods with the time it would normally take to sell the underlying assets, for example the Long-Term Asset Fund (LTAF). However, until the investment platforms accept funds with notice periods, there is likely to be a limited number of LTAFs for DC pension schemes to invest in. Usually, a good proportion of the investments in a DC pension scheme is not required to be converted to cash immediately so notice periods or deferrals for redemptions should not be an issue for DC pension schemes. We would suggest:

1. if trustees are having difficulty finding investment platforms through which they can invest in illiquid assets this should be disclosed to their members.
2. investment platforms should:
 - cover a diversity of liquid to less liquid (often called "alternative" products) taking into account the outcomes for the pension holders and need to optimise long-term returns; and
 - if they only offer daily dealing products, they need to justify why daily liquidity is necessary and beneficial to members.

We have included with this response a report "Returning to the Core: Rediscovering a Role for Real Estate in Defined Contribution Pension Schemes". This was commissioned in 2013 by AREF, along with the Investment Property Forum (IPF), European Public Real Estate Association (EPRA) and the Institute and Faculty of Actuaries (IFoA). The report mentions, on page 40, the fact that DC pension schemes and their platforms have adopted processes that require daily pricing and liquidity and were not willing to adapt these to invest in illiquid assets. We are disappointed to see that this is has not changed nine years later.

¹ The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £72 billion under management on behalf of their investors, including £18 billion on behalf of retail investors in the UK. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the AREF/IPD UK Quarterly Property Funds Index and the AREF/IPD Property Fund Vision Handbook.

We have noted below a few minor changes we believe are required in the draft guidance and regulations to either provide more clarity or reflect correctly what actually happens in practice.

Draft Regulations

Definition of eligible performance fee

Amendment of the Occupational Pension Schemes (Charges and Governance) Regulations 2015

In regulation 2, after paragraph (1A)(c) insert—

“(1B) When determining whether or not fees, or any part of those fees are specified performance-based fees for the purposes of these regulations—

- (a) a rate, amount, period of time or term is pre-agreed if it has been agreed between the trustees or managers and the fund manager to whom the fees are payable, before the trustees or managers make the investments to which the fees relate;”*

We are concerned that the wording above could be read as a renegotiated fee would not be excluded from the charge cap. There are situations when there are sound commercial reasons for fees or hurdle rates to be renegotiated. We appreciate that the word “rate” could be interpreted as a fixed rate or a variable rate and that fund manager appointments in practice could contain such a mechanism for varying the fees. However, we would ask for this line in the regulations to be rewritten to give more clarity.

Also, we would like to point out that a pension fund may invest in a fund-of-funds or a separate account that invests in underlying funds. Performance fees may arise in the underlying funds and these would not have been pre-agreed at the time the initial investment in the fund-of-funds or a separate account was made;

Performance fees or profit share / carried interest

We believe the regulations need to be clear that they cover arrangements that are a fee and that are a share of profits. As we have mentioned in previous responses to consultations on the charge cap, we disagree that performance fees are actually a charge. Performance fees typically arise where a fund or portfolio delivers a return to investors that exceeds a pre-determined benchmark or hurdle. Carried interest, or a performance fee with similar characteristics, is not therefore really a fee at all, but rather a profit share and incentive allocated to the manager when the fund manager has delivered outperformance for the investor.

Payment of performance fees

Amendment of the Occupational Pension Schemes (Charges and Governance) Regulations 2015

In regulation 2, paragraph (1)(b):

(iv) after the definition of “single charge structure” insert—

““specified performance-based fees” means fees, or any part of those fees, which are—

- (a) payable by the trustees or managers of a pension scheme to a fund manager in relation to investments managed by the fund manager for the purposes of the scheme;”*

The above wording states that the fees would be paid by the trustee of a scheme. In reality the fees / profit share are paid from the fund not by the investor. The wording in the regulations require changing to reflect this.

Draft statutory guidance

More consistency and clarification with terminology

We suggest there should be more consistency and clarification with terminology:

1. In paragraph 24 of the guidance and in the “**Assessment of asset allocation**” on page of 6 of the regulation, the term “shares listed on a recognised stock exchange” is used. In the definitions in paragraph 25 of the guidance, “**Listed equities:** Shares in a company which are bought and sold on a stock exchange.” We are concerned by the assumption that shares listed on a stock exchange are, by definition, traded. It is possible to have securities

that are listed on a stock exchange for which there is no free float, the shares are not traded and the investment is illiquid.

2. The words “property” and “real estate” are both used, and we assume they have the same meaning. Hence, we suggest there should be a clarification like “*property (also known as real estate)*”

If you would like to discuss with us our response, please contact either myself (prichards@aref.org.uk) or Jacqui Bungay (jbungay@aref.org.uk), Policy Secretariat at AREF. Also, as our members invest in real estate and other real assets for various types of open-ended and closed-ended funds, in the UK and in other jurisdictions, we are always willing to assist DWP by sharing this wealth of knowledge and expertise.

Yours sincerely



Paul Richards
Managing Director, The Association of Real Estate Funds