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Dear Mr Eaton

DWP's consultation on improving outcomes for DC pension scheme members

Thank you for the opportunity to contribute to this consultation. We previously responded to the DWP paper, "*Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution schemes*" to which this is a follow-up and to FCA discussion paper DP18/10 on patient capital.

Background to John Forbes Consulting LLP

John Forbes is a consultant advising on the structure and operation of property funds. John was previously a partner at PwC and led their real estate business across EMEA as well as being the international subject matter expert on real estate funds. Whilst at PwC, he was the author of the 2012 report for the Association of Real Estate Funds (AREF), "Unlisted funds - lessons from the crisis". He was also the author of the 2017 report for AREF, "A review of real estate fund behaviour following the EU referendum".

John was the author of the 2017 AREF / INREV report "Cost Transparency in European Listed and Non-Listed Real Estate".

He chairs the Association of Real Estate Funds (AREF) Cost Transparency Initiative (CTI) & Expense Ratio Working Group. It has two roles:

- Working with the CTI to enable cost data for real estate funds to be recorded in a consistent and clear way on the templates.
- Reviewing AREF's Total Expense Ratio guidance.

He represents the real estate industry on the CTI Technical Expert Panel.

Response to consultation

We set out our responses to the consultation on the following pages.

Q1: We would welcome your views on the reporting of net returns – how many past years of net returns figures should be taken into consideration and reported on to give an effective indication of past fund performance?

We believe strongly that there should be a greater focus on value for money and performance in DC pension schemes. Excessive focus on cost without consideration of the value received in return is not to the long-term benefit of scheme members. This is particularly the case for long-term investment in illiquid assets. We would therefore strongly support the reporting of net returns.

We believe that the net returns should be risk adjusted.

We think that there are benefits to reporting over different time periods so we are not convinced that this should be a single number. Many property funds report returns in a table showing one year, two year, three year, five year and ten year net returns, which is easy to follow.

Q2: Do you think that the amending regulations achieve the policy aims of encouraging smaller schemes to consolidate into larger schemes when they do not present optimal value for members?

We are not able to comment on whether or not the regulations achieve the policy aim of encouraging consolidation. We support the policy aims, but believe that there are also other benefits from consolidation, in particular increased scale allows greater diversification in investments which can reduce risk. This links to our comment on risk adjusted returns in response to question 1).

We think that the development of Collective DC Schemes as envisaged in the Pension Bill increases the ability to invest in illiquid assets and reduces risk.

Q3: Do you believe that the statutory guidance increases clarity about the minimum expectations on assessing and reporting on value for members for specified schemes? Are there any areas where further clarity might be required?

We would make two broad observations:

1) As already outlined, costs should be considered in the context of the net, risk-adjusted returns that they generate;

2) The benefits of diversification need to considered in the context of market risk of investments. An attraction of investment in real estate and other illiquid assets is the non-correlation with the performance and risks of other asset classes.

Q4. Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?

The proposals largely mitigate the specific challenge of dealing with performance fees when members join or leave the scheme during the year.

Performance fees and carried interest may be accrued within the fund into which the pension scheme has invested, paid directly by the fund to the manager or accrued outside the fund as a liability of the investor to the manager, paid by being withheld from distributions or redemption proceeds.

There remain broader issues with the inclusion of performance fees within the charge cap. This is discussed further below.

Question 5: What should we consider to ensure a multi-year approach to calculating performance fees works in practice?

Question 6: We are proposing a five-year rolling period. Is this appropriate or would another duration be more helpful?

Question 7: We are proposing offering a multi-year option as an alternative to an in-year option for schemes. Do you have any suggestions for how to improve this offer?

Question 8: To what extent will providing a multi-year smoothing option give DC trustees more confidence to invest in less liquid assets such as venture capital?

Performance fees arise where a fund or portfolio delivers a return to investors that exceeds a pre-determined benchmark or hurdle. In particular, carried interest is a profit share allocated to the manager when a hurdle return for investors is achieved. Meting out punishment because the investments have delivered a higher than expected return for the scheme members seems a perverse outcome.

A multi-year approach partially mitigates this, and the longer the period over which costs are smoothed, the less risk there is of anomalies. It does not, however, eliminate the perverse results that arise from a fixed charge cap. As outlined in our answer to question 1), we believe that a greater focus on risk-adjusted net returns is more relevant than a rigid charge cap that includes performance fees and carried interest.

A longer period, and spreading generally, reduces the level of reliance on ongoing accruals of contractual fees that are based on estimates and also reduces the impact of differences in the accounting treatment and payment of performance fees. The net asset value of funds for reporting and trading purposes will in many cases accrue for estimated performance fees that are not treated as a liability in IFRS accounts as there is, for accounting purposes, insufficient certainty that they will crystallise.

By definition pension funds should be long-term investors, so we would suggest a ten year period.

We would also suggest a move to a target rather than a fixed cap, to be considered in the context of returns. I personally would be happy to pay fees in excess of a ten year cap if the consequence was a commensurate outperformance over ten years of the risk adjusted return. I am sure most scheme members would too.

Q9. Do the draft regulations achieve the policy intent? Do you have any comment on the definitions used?

Excluding the costs of holding physical assets is an essential feature of the charge cap. Moving the existing 2016 non-statutory guidance to a statutory basis is welcome, although we are not aware that reliance on this on a non-statutory basis has been a particular issue.

The reporting templates produced by the Cost Transparency Initiative, which is the new industry standard for institutional investment cost data developed by the Pensions and Lifetime Savings Association, the Investment Association and the Local Government Pension Scheme Advisory Board include a slightly more comprehensive property expenses breakdown. This is supported by the Association of Real Estate Funds and for the private markets template by the British Venture Capital Association. We would suggest that in the interests of consistency and clarity that this list is adopted as the definition. This is illustrated below:

7. PROPERTY EXPENSES
Property management fees
Property leasing costs
Property maintenance and repairs
Property utilities and service charges
Property void costs
Property insurance costs
Property valuation fees
Property failed transaction costs
Indirect property expenses
Other property expenses
Total property expenses

I sit as the real estate industry representative on the CTI technical expert panel and would be happy to discuss this point further.

In the list in Annex F, Capital Gains Tax is included as a transaction cost. This is incorrect. It should be included in “taxes”.

The definition of funds in paragraph 75 states *"We propose that schemes should look through all open-ended funds and all UK listed closed-ended investment funds and international equivalents".* This excludes unlisted closed-ended investment funds. In view of the attention given elsewhere to the treatment of carried interest, which arises in unlisted closed-ended investment funds, we assume that this is an omission rather than intentional.

The comments in paragraph 76 on REITs highlight the difficulties of the broad approach of focussing on charges rather than net returns. There is no fundamental difference between a fund, an externally managed REIT and internally managed REIT. Work undertaken on cost transparency in 2017 for the Association of Real Estate Funds and INREV, the organisation representing institutional real estate investors in Europe, determined that the net returns and running costs are very comparable. The costs as calculated for pension cap purposes will, however, be very different as the costs of running an internally managed REIT will be excluded. Although rarer, there are also internally managed funds.

Q10: Do you believe that the updated statutory guidance increases clarity about the minimum expectations on both the production and publication of costs and charges information? Are there any areas where further clarity might be required?

Q11: We propose that where the default arrangement includes a promise, the trustees of the scheme should be required to produce a default SIP.

We propose that this should be produced within 3 months of the end of the first scheme year to end after the coming into force date.

(a) Do you agree with this policy?
(b) Do you agree that the legislation achieves the policy?

Q12: We are proposing that, for relevant schemes, charges and transaction costs should be disclosed for any fund which members are (or were) able to select and in which assets relating to members are invested during the scheme year.

(a) Do you agree with this policy?
(b) Do you agree that the legislation achieves the policy?

Q13: Do you agree with this proposed change? Do you have any other comments on this topic?

We have no comments on questions 10 to 13, other than to repeat our view that there should be less focus on a fixed charge cap and more focus on *"improving outcomes for DC pension scheme members"* as suggested by the title of the consultation, which in our view is best achieved through improving long-term, risk adjusted returns.

Yours sincerely

John Forbes