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Dear Sirs

Enabling investment in productive finance

Thank you for the opportunity to contribute to this consultation. We previously responded to DWP consultation *on improving outcomes for DC pension scheme members*, 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"* 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

As outlined in our response to the previous consultations, 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.

As we also noted in our previous responses, we believe that 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.

We therefore welcome the proposal to exclude performance fees from the charge cap.

Response to specific questions

Q1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

Q1b: Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

Q1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

We are not a DC pension scheme, and we are commenting on real estate and infrastructure rather than private equity and venture capital. We believe that encouraging investment by DC pension schemes in real estate and infrastructure is consistent with the government's policy objectives and is a key reason for the recent introduction of the long-term asset fund (LTAF).

For the reasons outlined in our introductory comments, we believe that excluding performance fees from the charge cap will broaden the range of investments available to defined contribution pension schemes. We believe that carried interest and other performance-based fees should be regarded as a profit share rather than a fee.

We believe that, in order to evaluate performance-based fees, trustees of DC pension schemes will need to enhance their skills in analysing investment performance. We believe that this can also bring significant benefits to scheme members. We have previously commented on the excessive focus on cost and the lack of focus on value. It is in the best interest of scheme members to move forward from an approach that too much resembles Oscar Wilde's famous quote, "knows the price of everything and the value of nothing"

Q2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

Q2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

We believe that market competition is the best control to keep fees competitive, but this requires trustees of DC schemes to develop the skills to understand the fee implications of the products into which they are investing and also to better understand and evaluate the performance of those products. As mentioned previously, we believe that this would bring additional benefits to scheme members.

We would make two general observations:

- The DWP is encouraging consolidation among schemes. We believe that this will help to create the scale that allows schemes to invest in more complex products. This will allow the expertise to be developed to facilitate investment in illiquid assets but also to undertake the analysis required to determine if performance-based fees are providing value for money;

- The consultation concentrates on the risk that schemes might pay excessive performance-based fees, but does not properly address the benefit of performance-based fees as a risk mitigant. Where managers are entitled to a performance-based fee, the base fee should be reduced. In the event that performance is not delivered, the manager is paid less. The manager receives a higher fee if returns are better and a lower fee if returns are lower. The net return to scheme members is improved in both scenarios.

In terms of the detailed proposals, we have two specific concerns:

- We note an inconsistency in the text regarding "realised" returns. The word "realised" appears in the question but not in the text that precedes. Paragraph 52 refers to "capital appreciation" without any requirement that this is only from "realised" gains. We are concerned at the reference to only "realised" outperformance being rewarded. Many real estate funds are long term vehicles with performance fees that recognise total returns that incorporate unrealised gains or losses on the underlying investments. Investors "realise" those gains by selling or redeeming their units rather than the fund "realising" gains through disposals of investments by the fund. We believe that it is important that performance fees at the fund level can include unrealised gains where appropriate. Real estate funds where performance includes appreciation in the net asset value will have the underlying assets appraised by third party valuers in accordance with RICS "Red Book" standards;

- The examples suggest performance fees with absolute return hurdles. Other hurdles may be appropriate. Many real estate funds measure their performance against long-established peer group indices. Real estate fund performance fees often require outperformance against the peer group index rather than merely an absolute return.

Q3: Which of these conditions should the Government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

We do not see the need for additional conditions to be included in the regulation. We agree that guidance on acceptable structures would give confidence to more schemes to invest, and we believe that there is a strong interest in the investment management industry to help educate investors. For real estate as an asset class, we would encourage the DWP to consult with real estate industry trade bodies such as the Investment Property Forum and the Association of Real Estate Funds.

Q4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

We believe that clear and transparent disclosure is important, so we support the proposals.

For this to be possible, clear and transparent disclosure at the product level is also required.

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 includes disclosure of performance fees and we have previously suggested that DC schemes follow the lead of defined benefit schemes and adopt the templates. The templates include a main template appropriate for open-ended funds and private markets template developed by the British Venture Capital Association with input from the real estate industry suitable for closed-ended funds.

The Association of Real Estate Funds also require their member funds to disclose performance fees.

We commented on the treatment of real estate transaction costs in our response to the previous consultation. 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 was welcome, although we were not aware that reliance on this on a non-statutory basis had been a particular issue.

The CTI templates referred to above include a slightly more comprehensive property expenses breakdown than the new statute. This is supported by the Association of Real Estate Funds and for the private markets template by the British Venture Capital Association. We suggested 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

We are still of this view.

Q5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

Q5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

Provided that there is no mismatch in the definitions, we agree that the smoothing mechanism becomes unnecessary if performance fees are excluded from the charge cap. We are not able to comment on the need for transitional protection arrangements.

Yours faithfully

John Forbes