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DC Policy, Investment and Governance Team
Department for Work and Pensions
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Submitted via email to: pensions.investment@dpw.gov.uk

RE: Enabling Investment in Productive Finance

BlackRock¹ is pleased to have the opportunity to respond to the consultation on Enabling Investment in Productive Finance, 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

We support the DWP's proposal to add performance-based fees to the list of charges outside the scope of the charges cap. This will make a meaningful difference to pension schemes' ability to access new sources of investment returns, if they choose to do so, by making allocations to private markets that *they*, acting as fiduciaries to their members, deem appropriate in terms of overall level of exposure, specific asset class, and geography/location of investment. Their ability to do so is currently constrained by the interaction between the *fixed* level of the charges cap and the *variable* nature of performance fees, typically charged for these investment strategies. As overall institutional investor demand for capacity-constrained private markets continues to grow, there is a risk that without reform DC schemes will be unable to seek out private market opportunities on an equal footing to other classes of investor, meaning that those scheme members will miss out on opportunities to enhance returns accordingly.²

We agree with the DWP that it would be beneficial to accompany the proposed change with guidance for schemes to help ensure that any performance fee structures entered into are appropriately structured and are not mis-applied. Indeed, there has already been a significant amount of work on setting standards and developing guidance for performance fees undertaken by securities regulators across multiple jurisdictions covering calculation methodologies, disclosures, and choice of benchmarks or hurdles. Guidance specifically aimed at schemes, their trustees, and their investment advisors on how to take these rules and standards into account when assessing performance-fee-charging investment offerings would be beneficial.

An area of particular importance is the equitable treatment of investors. When performance fees are levied in an open-ended fund structure that allows investors to move in and out of a portfolio over time, it is critical that they only pay for the performance that they have benefitted from. Indeed, this principle is recognised throughout the regulation and guidance referenced above. While this is a complex issue and requires careful management, there are already established, effective performance fee / profit sharing mechanisms that are used in a range of existing open-ended investment products. Guidance should therefore include principles and best practises on how to apply this fairly.

Notably, however, the guidance, standards, and rules that currently exist for performance fees are largely principles-based, and avoid prescribing specific asset classes for performance fees, or the choice of benchmark or hurdle to be used. For the reasons outlined below, we would encourage that the same principles-based approach be reflected in any future guidance or rules aimed specifically for pension schemes.

Finally, we agree with the DWP that taking forward this proposal should be accompanied by clear disclosure requirements. As with other costs and charges, it is important that members are able to see the impact of all fees on their realised investment performance. Again, the existing body of standards, guidance, and rules, including the FCA Handbook, contain provisions on the appropriate disclosures that should accompany the use of performance fees.

² Over the past decade there has been a consistent positive premium for private credit over public credit, standing at approximately 2% as of November 2021. In private equity, while earnings multiples have increased in recent years, they remain attractive relative to public equity markets. See BlackRock 2022 [Private Markets Outlook](#), December 2021. Source for private credit premium: S&P (LCD) as of November 2021. Source for private equity premium: S&P (LCD) and CapIQ as of June 2021.

Responses to questions

Question 1a: 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?

Question 1b: 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?

Question 1c: 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?

Questions 1a, b, and c are answered together here.

We support the DWP's proposal to add performance-based fees to the list of charges outside the scope of the charges cap.

Investment returns are crucial to the success of the DC structure. End-savers in DC vehicles will benefit from accessing the investment opportunities presented by private markets due to the higher expected returns relative to public markets, as well as their ability to offer additional sources of real return (exceeding inflation). For example, over the past decade there has been a consistent premium for private credit over public credit, standing at approximately 2% as of November 2021. In private equity, while earnings multiples have increased in recent years, they remain attractive relative to public equity markets.³

Increasing allocations to private markets will also lead to portfolios that are less concentrated in global public equities and less reliant on lower-returning assets to achieve diversification. These asset allocation practices have been adopted by institutional investors globally and the UK DC market is keen to adopt them, too. To meet this demand, it is critical to give DC schemes the ability to access these types of investments on an equal footing with other institutional investors.

Investment management of these asset classes tends to have higher overall costs, and a different cost structure. Sourcing investment opportunities, as well as the ongoing management and oversight of assets, represents an additional cost for private markets, requiring high levels of expertise and specialised management. This translates into higher overall fees – frequently via a performance fee – to align incentives over the relevant time horizon. It is possible for schemes to access these asset classes with a 'blended' flat fee structure, but the trade-off for fee certainty is a higher overall fee, which would be incurred irrespective of performance.⁴ Also, notably, this does not reflect the fee structures used for other large institutional investors.

³ See BlackRock 2022 [Private Markets Outlook](#), December 2021. Source for private credit premium: S&P (LCD) as of November 2021. Source for private equity premium: S&P (LCD) and CapIQ as of June 2021.

⁴ Further analysis of the trade-off between flexibility and certainty in fees is available in our [response](#) to the DWP's April 2019 Consultation on Investment Innovation and Future Consolidation.

We continue to believe the current specification of the charge cap is not compatible with the use of performance fees. Fundamentally, uncertainty around realised investment performance – which can be ‘lumpy’ and notably larger in private markets – translates into uncertainty about the upper limit of performance fees that will be incurred, thus acting as a deterrent to schemes choosing to make investments into these asset classes.

This in turn represents a barrier that prevents schemes accessing the best private market opportunities, and therefore impacts member outcomes. Further, as institutional investor demand for capacity-constrained private markets continues to grow across the board, there is a risk that DC schemes will not be able to access these long-term investment opportunities.

We believe that placing performance fees outside the scope of the charge cap would create the opportunity for a new class of institutional investor to participate in these markets and enter into negotiation with providers on fees. While – for the reasons stated above – performance fees are standard practice in these markets and likely to remain so, entry of a new class of investor may well change market dynamics.

Question 2: 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?

Question 2a: 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?

Question 3: 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?

Questions 2, 2a, and 3 are answered together here.

We continue to believe that the charges cap has been a critical part of building trust and consent for auto-enrolment, a significant and positive development in the UK’s retirement and pensions policy. We further agree with the motivation behind the DWP’s wish to ensure members are ‘sufficiently protected from high charges’. It is important, however, to be clear what this means in the context of retirement savings. While it is important to avoid fees that are in any way excessive, whether a fee is ‘excessive’ or not cannot be determined in isolation from the returns delivered by the investment strategy. In other words, value for money can only be assessed on the basis of costs *and* investment outcomes. As discussed above, private market investment strategies often attract higher average fees, but also have higher expected returns over the longer term. And while we believe the proposal to exclude performance fees from the charges cap would be the right decision, in this context the right approach to end-investor protection is ensuring that performance fees are not mis-applied and are appropriately structured.

We do not see a significant risk of the proposed changes leading to performance fees being charged for strategies which did not apply them in the past. Industry practises around fee structures are already well-established and underpinned by international and regional rules and standards. It is highly unlikely that – to take the DWP’s example

– any manager would attempt to change fees for an index investment strategy to an ‘inflation plus’ model. This is due to strong price competition for what is a more substitutable solution offered by the investment management industry. Schemes – and the investment professionals advising them – could easily switch providers if they experienced a shift to non-standard charging structures for a given asset class or strategy. We therefore do not believe it is necessary or desirable to specify the asset classes to which the exemption would apply. Indeed, doing so would present practical challenges in defining how portfolios would qualify for each category; and thereby create the risk of regulatory arbitrage.

Nevertheless, as discussed above, it will be important that this change is accompanied with principles-based guidance on the structure, calculation, and application of performance fees. Many of these principles already exist in guidance and rules issued by international standard-setters, and by the FCA.

In 2016, the International Organisation of Securities Commissions (IOSCO) issued [Good Practice for Fees and Expensive of Collective Investment Schemes](#), with detailed but principles-based examples of good practise for how fees, including performance fees, should be applied in open-ended collective investment structures. This includes, for example, that performance fees should respect the principle of equitable treatment of investors; that they should be consistent with the objectives of the investment strategy; that fees levied are proportionate and allow investors to maintain an adequate share of their returns; and that investors are adequately informed of the fee and how it might impact their investment.

In the UK, the FCA updated its Handbook in 2019 following the Asset Management Market Study, with updated provisions (see [COLL 6.7.6](#)) on the use of performance fees, covering the choice and application of benchmarks or hurdles, and guidance on accrual periods and disclosures. Moreover, investment funds sold cross-border into the UK from the EU have since April 2020 been subject to detailed [guidelines](#) issued by the European Securities and Markets Authority (ESMA) covering performance fee calculation, consistency with investment objectives, frequency of crystallisation, negative fees and loss recovery, and disclosures.

Guidance aimed specifically at schemes, their trustees, and their investment advisors on how to take these rules and standards into account when assessing performance-fee-charging investment offerings would be beneficial.

Notably, however, none of the standards outlined above seek to define specific or typical hurdle rates or base fee / performance fee ratios, and we do not believe it would be appropriate to specify hurdle rates in any regulation that accompanied the proposed changes: while hurdle rates or benchmark selection are partly determined according to the characteristics and performance of the asset class, they are also the product of consultation between end-investors and asset managers, and are informed by the formers’ objectives and return targets. Work currently being undertaken by the FCA and The Pensions Regulator – which seeks to improve the comparison between schemes – is, we believe, a more appropriate way of ensuring performance fees are ‘typical’ with respect to the wider market, than prescriptive regulation.

Question 4: 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.

Yes, performance fees and their impact on net returns should be clearly disclosed to end-investors. Existing standards and rulemaking around performance fees, discussed under questions 2-3, include provisions on what constitutes appropriate disclosure. It is important to note, however, that there is an important conceptual distinction between transaction costs, i.e. the direct and indirect costs incurred when transacting in markets; and charges, i.e. fees levied by investment managers and other service providers.⁵

Question 5a: 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?

Question 5b: 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?

Questions 5a and 5b are answered together here.

Yes, if the proposed changes go ahead we believe it would be appropriate to remove the smoothing mechanism and pro-rating easement from the regulations. These mechanisms were intended to reduce the risk of performance fees breaching the charges cap, and would not be relevant if they are excluded from the fees that sit within the cap. We would defer to schemes that have made use of the mechanisms as to what an appropriate transition arrangement would look like.

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 improving DC schemes' ability to choose to access a wider range of investment opportunities.

⁵ We have discussed transaction costs in more detail in our [response](#) to the DWP's August 2020 Review of the Default Fund Charge Cap and Standardised Cost Disclosure.