AREF
The Association of Real Estate Funds

The Association of Real Estate Funds
Camomile Court, 23 Camomile Street,
London, EC3A 7LL
+44 (0)20 7269 4677
info@aref.org.uk
www.aref.org.uk

DC Policy, Investment and Governance Team

Department for Work and Pensions

By email: pensions.investment@dwp.gov.uk

18 January 2022

Enabling investment in productive finance

We, the Association of Real Estate Funds[1] (AREF), welcome the opportunity to respond to the above consultation.

We support the government's aim to reduce the scope of the charge cap to better accommodate well-designed performance fees that facilitate investment in long-term, less liquid assets. While such assets, including alternative assets, pose different governance challenges to investors compared to more traditional assets, they can offer investors higher returns as well as supporting investment diversification.

As we have mentioned in response to previous 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 allocated to the manager when the fund manager has delivered outperformance for the investor.

The charge cap was identified as a barrier to DC schemes investing in illiquid assets in Productive Finance Working Group's (PFWG's) "A Roadmap for Increasing Productive Finance Investment". We agree with PFWG that the focus should be moved from cost to long-term value for DC schemes which the proposals in the consultation aim to achieve. Although, as noted by the PFWG and acknowledged by the government, performance fees being included in the charge cap are not the only barrier to DC schemes investing in productive finance. Only once all of the barriers have been overcome will the scale of investment by DC schemes in productive finance increase significantly.

DC Schemes are experienced investors with fiduciary duties and strong governance. They should not be blocked from considering investments that they feel are suitable and would provide the returns they require for their members.

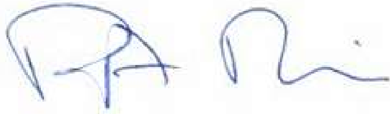
Although a more minor point, we would like to flag something that we raised in our responses to earlier consultations, we welcomed the exclusion of property level costs being moved to a statutory basis, we had suggested that the description of property level costs should match the Cost Transparency Initiative (CTI) template. If matched exactly funds could use CTI templates used for disclosure to defined benefit pension schemes.

Please find below a more detailed response to the questions. If you would like to discuss our response with us, 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 FCA by sharing this wealth of knowledge and expertise.

[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.*

AREF
The Association of Real Estate Funds

Yours sincerely



Paul Richards
Managing Director, The Association of Real Estate Funds

Response to consultation 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?

Although Q1a is addressed specifically to DC schemes, we are sharing our views. Exempting performance-based fees from the charge cap would make it more likely for DC pension schemes to consider investing in funds with performance fees where they believed it would be beneficial to their members. Whereas, currently fear of breaching the charge cap is putting off DC schemes looking at investing in funds with performance fees. The exemption will support the ability of DC schemes to invest in a broader range of assets where they feel it is in their members' interests to do so.

Performance fees are in essence a form of profit-sharing arrangement, which can strengthen the alignment of interests between investment managers and investors. Charge structures should be a matter of negotiation in the market, particularly in asset classes and strategies such as real estate where there may be capacity constraints. Trustees may still be deterred by performance fees as it will entail more work in evaluating and measuring relative performance. However, we believe that improving performance evaluation itself brings benefits for scheme members so we do not believe that this is a legitimate obstacle.

Although the consultation specifically refers to certain asset classes we would expect this consultation to also apply to real estate and other asset classes as well. This will ensure that DC schemes have the flexibility to consider the broadest range of asset classes when creating portfolios on behalf of their members.

It should be noted that in FCA PS21/14 LTAF, the FCA confirmed that the rules for authorised funds do not contain any caps on fees. managers are expected to undertake an annual assessment of value. The FCA are content to allow the market to decide the appropriate structure and amount of any performance fees based on full disclosure for LTAF. Similarly, trustees should be given the ability to consider investing in funds with performance fees, without worrying about breaching a charge cap, and fully disclose the benefits of this to scheme members.

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 support the Government's proposal and are not aware of any other solutions that would meet the Government's stated objective to support investor's ability to invest in a broader range of assets while maintaining the protection of the charge cap.

AREF
The Association of Real Estate Funds

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?

DC schemes would only invest in a funds with performance-based fee structures that provide genuine outperformance. If this is not the case, the DC scheme would not invest in the scheme. Therefore, we do not believe there is a need for government to put any "protections" in place. We would make the following specific points:

- It is important that trustees of DC schemes increase their focus on performance and only invest in products where the nature and level of performance fee is appropriate for the product. As outlined in our introductory comments, we believe that an increased focus on value rather than cost will improve outcomes for scheme members;
- 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. We believe that it is important that performance fees at the fund level can include unrealised gains where appropriate;
- The examples suggest performance fees with absolute return hurdles. Other hurdles may be appropriate. Many real estate funds, including AREF member 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.

We do not believe that the market would allow funds to change fee structures to just fit within the easement.

In the consultation, it is mentioned that one potential solution is to be specific about the asset classes to which the performance fee exemption would apply. We believe that DC pension schemes should have the flexibility in a principles-based manner to consider the broadest range of assets in which to invest. There is already a significant amount of regulatory and supervisory material relating to fee structures in the asset management sector, including from the FCA, ESMA and IOSCO[2] Limiting the scope of an exemption to specific assets or strategies would distort how DC schemes determine the best investments for their members.

The introduction of an exemption for performance fees will place a greater onus on Trustees to ensure default investments provide value for members. The Government's focus should therefore be on supporting and monitoring good governance, particularly at the DC pension scheme level. Greater emphasis should also be placed on real net returns instead of costs and charges. We support the approach suggested by DWP in the consultation paper to develop guidance on what constitutes well designed performance fee structures. This will support the ability of DC pension schemes to assess whether fee structures are offering value for money.

[2] See COLL 6.7 Payments - FCA Handbook, https://www.esma.europa.eu/document/guidelines-performance-fees-in-ucits-and-certain-types-aifs and https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

AREF
The Association of Real Estate Funds

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?

AREF does not support the government adding any additional conditions to the performance fee definition. We support there being principle-based guidance for DC schemes on what constitutes well designed performance-based fee structures but this should not be prescriptive. Real estate funds use a broad range of performance fee structures. Providing DC schemes with a principles-based guidance would enable them to make an informed decision on whether a fund's performance fees are appropriate for their scheme and would enable them to achieve the investment return they are looking for. Also, this approach would future proof regulations to accommodate innovation on fee structures. Another advantage of adopting a principles-based approach is that investors will be entitled to consider the most appropriate factors when assessing whether fees are reasonable and proportionate to the expected returns without requiring them to adhere to pre-determined structures.

There is already a significant amount of regulatory and supervisory material relating to fee structures in the asset management sector, including from the FCA, ESMA and IOSCO. Building on this material and existing industry practices will ensure DWP guidance aligns with existing practices and support the ability of investors to evaluate fee structures across different assets and investment strategies

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.

AREF agrees with the proposal that performance-based fees, exempted from the charge cap, should be disclosed to members. Any disclosure requirements should be proportionate and reflect the value of the investment more broadly rather than focus solely on costs. AREF member funds are already required to disclose performance fees and transaction costs so this information would be available to DC schemes.

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?

AREF agrees that if performance fees are added to the list of charges which are not subject to the charge cap, the performance fee smoothing mechanism and the pro-rating easement could be removed.

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?

We believe it would be prudent to put in place transitional protection arrangements for schemes that have decided to make use of the performance fee smoothing mechanism.